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REPORTING FOREIGN OPERATIONS

by
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REPORTING FOREIGN OPERATIONS

By

Samuel R. Hepworth

It is the purpose of this study to examine the problems related to the expression in dollars of the financial position and operating results of foreign subsidiaries of United States corporations with particular consideration of the impact of government control of currency convertibility and exchange rates.

The first section includes an investigation of the appropriate methods for the translation of accounts initially expressed in a foreign currency into dollars. Separate attention has been given to balance sheet as compared with income statement accounts and the measurement of the gain or loss resulting from exchange rate movements has been examined in detail. In the second section the forms and purposes of government control of currency convertibility and exchange rates have been examined with particular emphasis on the impact of controls on the reporting of the financial position and operating results of foreign subsidiaries. The final section considers the desirability of incorporating the financial statements of foreign subsidiaries with those of United States corporations in consolidated financial statements. The possibility of employing partial or hybrid consolidation methods in order to give special recognition to foreign net assets and earnings is illustrated by reference to published financial statements.

It was concluded that foreign currency accounts which represent a fixed number of foreign currency units should be expressed in dollars by application of the exchange rate which is in effect on the date of the translation, and that real value assets should be translated by use of the acquisition date exchange rate. Foreign currency revenues and expenses should be expressed in dollars by application of the exchange rate in effect when the respective amounts

were earned or incurred, but as a matter of practical expediency the use of month-end rates is acceptable. It is essential that the translation of foreign currency revenues and expenses result in a reasonably accurate measurement of the exchange gain or loss as the change in the dollar value of foreign currency money value net assets.

Restrictions on the convertibility of the foreign currency into dollars for transmission to the United States have no necessary impact on the translation of foreign balances or the recognition of foreign earnings. Orly if the real effect of such restrictions is to limit the freedom of administration of the assets of the foreign subsidiary should recognition by the parent corporation of unremitted subsidiary earnings be considered to be improper. When a foreign country has a number of exchange rates in effect at the same time, the rate which is applicable to financial remittances should be employed for translation purposes. It was concluded that the devaluation of a foreign currency represents the adoption of a new currency unit and the pre-devaluation rate should be abandoned for the translation of foreign currency accounts.

The propriety of the inclusion of the accounts of foreign subsidiaries in consolidated statements depends upon the existence of effective control of the affairs of the subsidiary and a reasonable degree of homogeneity of operating characteristics between parent and subsidiary. The impact of exchange restrictions on the effectiveness of parent company control must be considered, but the existence of controls must not be considered to represent sufficient evidence to require exclusion of foreign subsidiary accounts from consolidation.

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PREFACE

During the last half century a tremendous increase in the amount of foreign investment by individuals and corporations in the United States has taken place. The magnitude of this increase is indicated by the following amounts which represent the value of United States direct foreign investment, expressed in billions of dollars:

Year	Amount
1897	.6
1929	7.5
1943	7.9
1950	11.8[1]

Of the 1950 total of 11.8 billions of dollars, approximately 71% represented the dollar net asset value of foreign subsidiaries of United States corporations.[2] These data serve to emphasize the importance of the development of sound procedures for the reporting of financial position and operating results of foreign subsidiaries of United States corporations.

The last fifty years have also witnessed material alterations in the environment in which foreign investment is undertaken and continued. During the early part of this period the currencies of the important commercial countries were generally closely tied to and fully convertible into gold, with the result that fluctuations in exchange rates were restricted to amounts above and below the gold parity of various currencies equal to the cost of transporting gold internationally. The existence of relatively narrow limits on the magnitude of exchange rate fluctuations, together with generally unlimited convertibility of currencies, minimized the problems

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[1] United States Department of Commerce - Office of Business Economics, Foreign Investments of the United States (Washington, D.C., 1953) p. 4.

[2] Ibid, p. 17.

of reporting foreign operations and financial position in terms of the currency of the parent corporation. The general abandonment of the gold standard and the emergence of a variety of forms of governmental regulation of international financial transactions, such as limitations on currency convertibility and control of exchange rates, have introduced a wide variety of new problems into the process of reporting the results of foreign operations.

The preceding paragraphs indicate that the reporting of foreign operations has taken on increased significance both because of the substantial increase in the magnitude of foreign investment as well as the increasing impact of governmental action in connection with the ability to transmit funds internationally and with the terms of currency conversion. It would be expected that the literature relating to the problems of reporting foreign operations would show a parallel development. Such is not the case, however. Textbook material, periodical literature, and even the recommendations of professional societies still consider the techniques which were appropriate in the days of unrestricted convertibility and the reassuring ties to gold to represent the basic principles relating to foreign currency reporting. Piecemeal modifications of historical procedures have been suggested when particular techniques were clearly out of touch with reality, but no attempt has been made to examine all facets of the problem of reporting foreign operations in a thorough manner and to offer revised methods in view of the altered international environment.

It will be the objective of this inquiry to explore the major problem areas related to the reporting of foreign operations and to suggest accounting and reporting techniques which reflect current conditions and which are compatible with rational accounting principles. The areas to which particular attention will be devoted include the translation of foreign

currency accounts into dollars, the measurement and significance of the gain or loss resulting from exchange rate movements, the form and impact of governmental restrictions in relation to international financial transactions, and the desirability of and techniques for fully or partially including foreign currency accounts in consolidated financial statements.

CHAPTER I

TRANSLATION OF ACCOUNTS EXPRESSED IN FOREIGN CURRENCIES INTO DOLLARS-BALANCE SHEET ACCOUNTS

The principal accounting problem created by the operation of a subsidiary corporation in an area or country employing a monetary unit different from that of the country in which the parent enterprise is domiciled is that of expressing the financial position and operating results of the foreign subsidiary in monetary units which are homogeneous with those employed by the parent company.[1] This process of achieving homogeneity in monetary units is conventionally described as that of converting or translating account balances expressed in terms of a foreign currency into dollar balances. The present chapter will deal with the objectives of the translation process, the conditions under which translation is inappropriate, the general criteria governing the process of translating foreign balances into dollars, and the application of these general criteria to specific asset, liability, and net worth accounts. The translation of revenue and expense account balances will be discussed in the succeeding chapter.

Need for Translation of Foreign Balances

The immediate objective of the process of translating foreign account balances into dollars has already been set forth; namely, that of achieving an expression of the financial position and operating results of the foreign subsidiary in the same monetary units in which the transactions of the parent enterprise are expressed. Underlying this result is the more fundamental

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[1] At this point, the special problems arising from current international monetary restrictions are not considered in detail.

objective of achieving a manner of expression of the financial data of foreign subsidiaries which will create a maximum degree of understanding of such data on the part of the management, creditors, and stockholders of the domestic parent enterprise. There would seem to be little question but what these groups, accustomed as they are to thinking in terms of dollars and cents, can derive maximum utility from financial data expressed in terms of monetary units to which their thinking in such matters is conditioned. It must be recognized that international monetary conditions may exist (presumably, or at least hopefully, of a relatively temporary nature) which will render the results of the translation process more misleading than informative. These conditions will be considered in general in the succeeding section of this chapter and more specifically in Chapter IV.

At the technical accounting and reporting level, the translation of account balances expressed in foreign currency units into dollar amounts is necessary for several reasons.

It is generally recognized in the case of parent and subsidiary corporate relationships involving only domestic corporations that where effective common control of corporate policies and procedures through the medium of ownership of a substantial portion of voting shares exists, coupled with a reasonable degree of homogeneity of type of operations, e.g., product or service supplied, that a combination or consolidation of the financial statements of the related corporate entities into a single set of financial statements for the larger economic entity may provide useful information. Ignoring for the moment the impact in this connection of currently existing international monetary restrictions, it is apparent that in situations in which the conditions just mentioned exist, the consolidation of the accounts of foreign subsidiaries with those of the domestic parent company may produce informative data. Obviously, the consolidation

of the accounts of a foreign subsidiary with those of the domestic parent requires expression of both sets of accounts in the same currency units. Since the resulting consolidated financial statements are primarily for the use of persons accustomed to thinking in terms of the currency units employed by the domestic parent company, it is only logical to employ such currency units in the consolidated statements, thus requiring the translation of the accounts of the foreign subsidiary into domestic currency. The entire question of the consolidation of foreign subsidiaries is considered in detail in Chapter V.

In situations in which conditions such as a lack of similarity in type of operations or products of the related corporate entities render a complete consolidation of individual account balances illogical, a possible alternative is to carry the account reflecting the investment in the foreign subsidiary on the parent company's books and financial statements at an amount equal to the parent company's equity in the recorded net assets of the subsidiary. This technique differs from the results of a complete consolidation of the accounts only in that the net assets of the foreign subsidiary are reflected in a single account rather than being combined throughout the consolidated balance sheet with similar parent company account classifications. This procedure was employed for a number of years by Standard Oil Company of California, which described the policy in the following note:

> The investment in wholly owned subsidiary companies operating in foreign countries is carried in the consolidated balance sheet at the book value of the underlying net assets, less reserves, and the profits or losses of these companies are included in the consolidated statements of income and surplus. Items recorded in foreign currencies have been expressed in United States dollars at appropriate rates of exchange.[2]

As indicated by the concluding sentence of the above note, the use

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[2]Standard Oil Company of California, Annual Report (1948).

of this procedure also requires translation of the accounts of the foreign subsidiary into dollars in order to determine the proper carrying value of the investment in foreign subsidiaries in currency units compatible with the remainder of the parent company (or consolidated) statements.

A third alternative to the methods outlined above, e.g., complete consolidation or carrying the investment at net asset value expressed in dollars, is that of carrying the investment in foreign subsidiaries on the books of the parent company and in its (or a domestic consolidated) balance sheet at the dollar outlay to acquire the shares of the subsidiary. At first glance it would seem that this would completely avoid the problem of translation of the accounts of the foreign subsidiary. However, it is fairly common reporting practice, in cases in which the investment in foreign subsidiaries is carried at cost, to present supplementary schedules or tabulations, often in the text section of the annual report, setting forth the underlying net asset value and equity in the net income of the current year, both expressed in dollars. This procedure is in line with recommendations of the American Institute of Accountants relative to adequate disclosure of information relating to foreign subsidiaries.[3] Examples of such tabulations as contained in recent published corporate reports are presented in Chapter V. Hence, even when the investment in foreign subsidiaries is carried at dollar cost it is typically necessary to come to grips with the problem of translating foreign account balances into domestic currency units.

Conditions Rendering Translation Inappropriate

The preceding section has indicated that in the typical case of a domestic parent-foreign subsidiary relationship, translation of foreign

[3]American Institute of Accountants-Committee on Accounting Procedure, Accounting Research Bulletin Number 4-Foreign Operations and Foreign Exchange (December, 1939).

balances into dollars is necessary, regardless of the policy as to consolidation or in the absence of the preparation of consolidated financial statements, regardless of whether the investment account is carried at equity in subsidiary net assets expressed in dollars or at dollar cost. Under conditions of free movement of exchange rates resulting from unrestricted international movement of funds there is little question as to the validity of this position. Unfortunately, however, such freedoms have been severely restricted during the last twenty years. In their place we are confronted with a variety of restrictive conditions including a complete absence of any sort of trade or exchange transactions with Soviet Russia, restrictions on the movement of funds or at least restrictions as to the purpose for which funds may be withdrawn, and the existence of a "family" of exchange rates for various types of transactions. While detailed consideration of the impact on accounting techniques of such restrictions is deferred until Chapter IV, the existence of extreme restrictions may well serve to make any attempt to translate foreign balances into dollars meaningless at best, or, in some cases even misleading. Since such restrictions are prone to vary rather widely from country to country, and to be subject to rapid adjustment, removal, or extension in a single country it is difficult, if not impossible, to promulgate rigid criteria to employ in reaching a decision as to the appropriateness of translation in a particular case. Rather it is necessary to examine the characteristics of a particular case at the particular time and to attempt to reach a decision as to the validity of the results of the translation process and the appropriateness of the resulting dollar figures for inclusion, directly or indirectly, in the accounts and reports of a United States corporation. The following statement, written in late 1947, and hence subject to modification for changes since that date, indicates the type of conditions which might

render the translation of foreign balances inappropriate.

> Dollar transactions with countries under Russian control, such as Rumania, Hungary, and others are practically non-existent; countries such as Germany and Austria have effective legal exchange rates for military and occupation purposes only. Italy has different legal rates....for various types of transactions; the country has had three major devaluations from the middle of 1943 to last August (1947) showing continued instability and lire dividends cannot be converted to dollars.
>
> In all the foregoing cases, dollar figures at any exchange rates would be meaningless, if not actually misleading. If financial information is issued for subsidiaries in the above-mentioned countries it should be expressed in local currencies and not in dollars.[4]

In the opinion of the author, the conclusion expressed in the preceding quotation as to conditions which may render the expression of foreign accounts in dollars inappropriate represents an over-conservative point of view. Certainly in situations in which there are no transactions, financial or otherwise, with a particular country, translation of local currency units into dollar figures would be meaningless. However, in this situation it would seem to be appropriate to eliminate or at least substantially reduce the recorded cost of the investment as carried on the books of the domestic parent company. Under these conditions it is doubtful if any data relative to the financial position or operating results of the subsidiary would be available for translation into dollars. On the other hand, the existence of a variety of exchange rates, limitation or prohibition of the payment of dividends which can be converted to dollars, or even a record of substantial currency devaluations would not seem to eliminate completely the desirability of converting foreign balances into dollars. Of course, as previously indicated, it is necessary to give careful consideration to the facts of each case and, without question, adequate disclosure of such restriction is essential for satisfactory reporting. The alternative to conversion of foreign

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[4] A. B. Hecker, "How to Handle Foreign Currencies in Statements Covering Foreign Subsidiaries," Journal of Accountancy, January, 1948, pp. 26-29.

balances, namely expression in terms of local currency units, is at best of doubtful value in terms of information conveyed thereby to those accustomed to thinking exclusively in terms of dollars. While this technique has not been commonly employed in the published reports of United States corporations, an interesting example thereof appeared in the 1940 annual report of National Dairy Products Company. In this report, foreign subsidiaries are excluded from the consolidated statements, and the investment in such subsidiaries is carried on the consolidated statements at cost less a valuation reserve to provide for possible future losses. A supporting schedule is included in the report which states the following amounts for foreign subsidiaries:

Year ended December 31, 1940 (or nearest fiscal year closing):
- Net Sales
- Equity in net profits

December 31, 1940 (or nearest fiscal year closing):
- Net current assets
- All other assets - net
- Equity in net assets
- Investment and advances (as carried on the books of the parent company)

For subsidiaries located in Canada, England, and Argentina the amounts included in the tabulation are expressed in dollars, which provides a reasonably informative basis for comparing the cost of the investment with the current equity in net assets, expressed in dollars. However, for subsidiaries located in Germany, The Netherlands, Belgium, and Australia the amounts relating to the subsidiaries' records are expressed in local currency units. There would seem to be serious doubt as to the value to an American analyst or investor of comparing an equity in net assets of a German subsidiary of 1,730,290 Reichsmarks with a cost of such investment of $178,952.71.

In summary, it would seem that if relations between the United States and a country in which a subsidiary corporation is domiciled are such as to justify the attaching of any value on the records of the parent company to

the investment in such subsidiary, the expression of the financial position and operating results of the subsidiary in dollar figures is appropriate. The resulting dollar balances may be used for purposes of consolidation with the accounts of the parent company or only for comparing the equity in net assets with the dollar cost of the investment or equity in net profits with dividends received in dollars.[5] The existence of a variety of exchange rates, currency devaluations, or restrictions on payment of dollar dividends should be fully disclosed in connection with the converted balances, but the existence of such restrictions should not per se be considered as preventing the informative translation of foreign account balances.

Basic Criteria for the Translation of Foreign Accounts

American literature dealing with the subject of the accounting problems created by the existence of subsidiary corporations, the financial records of which are expressed in currency units differing from those employed by the domestic parent company has been both sparse and inadequate. While most accounting textbooks at the intermediate or advanced level include one or more chapters dealing with problems related to the operation of foreign branches or subsidiaries, the material contained therein traditionally boils down to a recitation of the mechanical rules for translating various types of accounts into dollars, with little if any consideration of the objectives underlying the translation process or of the significance of the translated balances. The American Institute of Accountants has devoted one Accounting Research Bulletin to the subject of foreign operations and foreign exchange[6] together with a special statement on accounting problems created by currency

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[5]The alternatives in this connection are considered in Chapter V.

[6]American Institute of Accountants-Committee on Accounting Procedure, op. cit.

devaluations.[7] Here again there is no inquiry into the fundamental objectives of the process of translating foreign balances, much of the material in both the Bulletin and the Statement being concerned with the desirability of conservative reaction to current restrictions in the foreign exchange field. It seems essential to the author that any formulation of specific procedures for the translation of foreign accounts must be preceded by a careful consideration of the purpose for which the accounts are being translated and the framework, in terms of accounting principles, into which the translated balances are to be fitted. A preceding section of this chapter indicated the uses which may be made of the financial data of foreign subsidiary companies after the conversion thereof into domestic currency. It will be recalled that these ranged from consolidation with the accounts of the domestic parent company to use, apart from the actual financial statements, for purpose of comparison with dollar amounts included in parent company statements (cost of investment or dividends received). Hence, in all cases the translated balances are to be combined with or compared with the results of the application of "generally accepted accounting principles" as they may exist at the present time. It would seem logically necessary, therefore, that translated foreign balances emerge which reflect the same fundamental accounting principles as have been applied to the related domestic accounts. In general the accounting principles which are of primary importance in this connection relate to the valuation of assets and liabilities. In the section which follows, in which translation procedures applicable to particular asset, liability, and net worth items are discussed in detail, the following valuation principles will be observed relative to the items under consideration:

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[7] American Institute of Accountants-Research Department, Accounting Problems Arising from Devaluation of Foreign Currencies, November, 1949.

Current assets (exclusive of inventories and prepaid expenses)- Realizable value.

Inventories and prepaid expenses - Original cost or lower of original or replacement cost.

Property, plant, and equipment - Original cost, less consumption thereof through operations (depreciation).

Liabilities (both current and long-term) - Amount payable at maturity.

Net Worth - Difference between asset and liability values, divided between the original contributed capital and the excess of total net worth over such amount (earned surplus or retained earnings).

The techniques of translating particular items, as discussed in the succeeding section, will be aimed at producing dollar figures which fit into the above framework of valuation principles. This means that no attempt will be made to incorporate recognition of the changing domestic value of the dollar into the translation procedure. This should not be interpreted as a denial of the critical need for the development of accounting techniques which come to grips with the problem of the varying economic significance of our monetary unit, but merely the reflection of a conviction that the translation of foreign balances into dollars and the recognition of changing internal value of the dollar, although similar in many respects, are fundamentally separate and distinct.

At the present time, prevailing practice relative to the conversion of foreign assets and liabilities is prone to group such assets and liabilities into the conventional balance sheet classifications of current and non-current, and to select the appropriate exchange rate to be employed in the translation process on the basis of the nature of an item from this point of view. With rare exceptions, current textbook material on the subject as well as the pronouncements of professional societies suggest that current assets and liabilities should be translated at the exchange rate which is current on the date of the balance sheet which is being translated, and that

non-current assets and liabilities be translated at the exchange rate which was effective when the asset was acquired or the liability incurred.[8] The following statement of conversion "rules" indicates the prevailing point of view:

> Current assets (including the final inventory) and current liabilities: at the rate which is current at the end of the period.
>
> Fixed assets: at the rate which was current at the time the assets were purchased.
>
> Long-term liabilities: at the rate prevailing when the liability was contracted.[9]

In the opinion of the author, the current - non-current classification is of much less value than is commonly attributed to it for purposes of conventional financial statement analysis, representing to a considerable degree a bow in the direction of traditional analytical procedures of banks and other short-term lending institutions. When the same classification technique is carried over, substantially without modification, to the problem of translating foreign account balances, the results are, at best, misleading, and, as a more careful examination will indicate, actually incorrect. The initial source of error, in relation to the problem at hand, stems from the fact that current assets, as conventionally defined, do not represent a completely homogeneous group of items, particularly in relation to the problem which is being examined here. Since we are essentially dealing with the problem of expressing the proper values of assets and liabilities in terms of currency units different from those in which their value

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[8] Such exceptions as do exist relate to the effect of special currently existing conditions such as devaluation of a foreign currency. In the absence of such presumably abnormal conditions, the current vs. fixed classification for translation purposes would probably not be questioned.

[9] H. A. Finney and Herbert E. Miller, Principles of Accounting-Advanced (New York: Prentice-Hall, Inc., 1952), pp. 595-596.

was originally recorded, our concern is with money-values. Quite apparently there is a distinct difference between cash or short-term contractual claims to a fixed amount of cash (accounts receivable) as opposed to inventories of merchandise or expense prepayments. The first category represents a clearly defined money-value (in terms of foreign currency units for the purpose of this discussion) while the latter represents only a potential currency value, which is traditionally valued from the point of view of past money outlay, with the estimated value in terms of money inflows exercising an effect only in special circumstances.[10]

A second source of error, from the point of view of translating foreign balances, of the current - non-current distinction appears when we consider the nature of liabilities or debts. From the point of view of the proper dollar valuation of obligations payable by a foreign subsidiary in foreign currency there is no fundamental difference between current accounts payable and long-term bonds payable. Both represent a contractual obligation to disburse a fixed number of foreign currency units at a date subsequent to that on which the translation into dollars is being performed. In principle, each type should be converted into dollars at the rate of exchange which is expected to prevail on the date on which the particular liability is payable. Due to the inherent, and certainly understandable in the case of foreign exchange rates, hesitancy on the part of accountants to incorporate predictions of future events into the accounting process, the rate which is effective on the date of the translation is resorted to as the best available objective datum. On rational grounds, however, the current rate would be applicable to both current and long-term liabilities, with full recognition

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[10] Such as the recognition in Accounting Research Bulletin Number 29 of net realizable value as a factor to be recognized in the proper application of the "lower of cost or market" rule to inventory pricing.

that in neither case does its use achieve perfect results. Traditionally, long-term liabilities, as previously indicated, have been placed in the same basket with fixed assets and have been translated into dollars at the rate effective when the liability was incurred, the expressed reason being to avoid recognition of unrealized gains or losses resulting from exchange rate fluctuations. There seems little validity, however, in intentionally eliminating a factor which results from the fundamental phenomenon which creates a problem when dealing with foreign currencies, namely, variation in the dollar value of foreign currency units. In addition, it would seem to be somewhat inconsistent to advocate the recognition of unrealized gains or losses in dollar value of foreign currency items at one point (net current assets) and to consider its recognition improper at another (long-term debt). In fairness to the American Institute of Accountants, it is essential to mention that the most recent pronouncement of this organization on the subject at hand grudgingly admits that translation of long-term liabilities at current rates of exchange may be appropriate when a major devaluation of the foreign currency has occurred since the creation of such liability.[11]

The conclusion which follows from the preceding discussion is that the logical classification of assets, liabilities, and net worth items for purposes of translation of foreign balances into dollars is a division between those items which represent a contractual right to receive or pay a fixed number of foreign currency units, currently or in the future, as contrasted with items the value of which may vary in terms of the foreign currency unit. It is interesting to observe that this distinction between money-value assets and liabilities and non-money-value items has been recognized rather clearly in English literature on the subject. The terms

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[11] American Institute of Accountants-Research Department, op. cit.

"currency assets and liabilities" as distinguished from inventories is employed in one of the earliest articles on the subject of foreign exchange.[12] A precise statement of the correct division of foreign accounts, for the purpose of translation, is contained in one of the few searching inquiries into this subject which current literature offers (also of English origin) in the following words:

> .....the significant line of demarcation in the balance sheet does not lie between current and fixed items, but between (a) rights and obligations that are defined in terms of money (including even preference shares), and (b) forms of wealth whose money value can alter freely.[13]

This classification will be observed in the pages which follow, in connection with the discussion of translation procedures for specific asset, liability, and net worth items.

Another basic criterion which will govern the selection of specific translation techniques in the remainder of this and the succeeding chapter relates to the significance of the familiar exchange gain or loss or exchange adjustment item. The application of what may be called conventionally recommended translation rules results in the necessity of inserting in the converted trial balance a balancing figure or "plug" to balance the trial balance expressed in dollars. This balancing figure is typically recognized as being some form of unrealized gain or loss occasioned by movement in exchange rates, since, if exchange rates did not change, all items in the foreign trial balance would be translated at the same rate and no balancing figure would be required. However, rarely in American literature on the subject can any attempt to analyze the exchange adjustment rationally and

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[12] Herbert A. Plumb, "Treatment of Fluctuating Currencies in the Accounts of English Companies," Accountant, April 4, 1891, pp. 259-271.

[13] W. T. Baxter and B. S. Yamey, "Theory of Foreign Branch Accounts", Accounting Research, April, 1951, pp. 117-132.

to identify specifically the cause thereof be found. In the pages which follow, and particularly in the succeeding chapter dealing with revenue and expense items, translation procedures will be advocated which restrict the exchange adjustment to what it should logically represent, namely the gains or losses caused by changing dollar value of foreign assets and liabilities which represent contractual rights to cash or to the receipt of cash or contractual obligations for the disbursement of cash. Only if this is the case does the exchange adjustment have real significance in terms of managerial action and responsibility placement.

Before leaving the subject of basic criteria for the translation of foreign accounts, it is appropriate to inquire as to what, if anything, regulatory bodies have contributed to the development of fundamental principles. The answer, unfortunately, is nothing. As might be expected, the Securities and Exchange Commission is the only regulatory agency which is particularly concerned with the subject, and its pronouncements are indeed sparse. Regulation S-X states, under Rule 3-09 entitled Conversion of Items in Foreign Currencies, that "the basis of conversion of all items in foreign currencies shall be stated, and the amount and disposition of the resulting unrealized profit or loss shown". In addition Accounting Release Number 11, issued January 4, 1940, deals briefly with considerations relative to the inclusion of the accounts of foreign subsidiaries in consolidated statements in view of war conditions and currency restrictions.

Having surveyed the reasons for translating foreign balances, the conditions under which translation may be inappropriate, and, most important, the basic principles governing the translation process, we are prepared to turn to an examination of recommended translation procedures for specific accounts. The remainder of this chapter will deal with balance sheet (asset, liability, and net worth) accounts, Chapter II with the

translation of revenue and expense accounts, and Chapter III with the problem of the resulting exchange gain or loss.

Translation of Specific Balance Sheet Items

Before examining the translation procedures applicable to specific balance sheet accounts, it is appropriate to reiterate that consideration of the special problems created by the existence of various restrictions in the foreign exchange area including the existence of multiple exchange rate structures, is deferred until Chapter IV. Hence, in the following section the discussion will avoid, except by reference, the effect on the translation process of the existence of such restrictions.

Cash

The translation of foreign cash balances presents little difficulty, in view of the principles previously enunciated. Quite obviously cash represents the very essence of a money-value item and as such expression of foreign cash in dollars by application of the closing exchange rate in effect on the date of the cash balance being translated represents the logical procedure.

The problem created by subsidiary cash balances in excess of present or potential operating requirements, caused by restrictions on the remittance of cash to the domestic parent company will be considered in Chapter V.

Temporary Investments

Available published data indicate that the use of temporarily excessive cash to acquire foreign securities in substantial amounts is not a typical policy of foreign subsidiaries of United States corporations. Even when foreign cash balances far exceed current or potential operating requirements, because of restrictions on the transmission of such funds to the domestic parent company in the form of cash dividends, there appears to be little inclination to commit any substantial portion of such funds to investment in

foreign securities. For example, the 1950 annual report of General Motors reveals restricted foreign cash of $16,198,204 with no visible indication of any temporary investments in foreign securities.[14] Hence, it appears that the question of the proper translation of temporary investments of foreign subsidiaries is not of major importance on quantitative grounds. However, from the point of view of correct analysis at the accounting level, the translation of foreign temporary investments introduces some interesting problems to which attention should be directed.

It seems reasonable to assume that where temporary investments of excess cash are made by a foreign subsidiary, the form of such investment will be governed by the same criteria that influence the choice of temporary investment media by a domestic corporation. These criteria would include the absence of any substantial degree of internal risk, stemming from the character of the issuer, and as a corollary, relatively stable market prices, at least over a short period. This would indicate that the temporary investments would typically take the form of some sort of bonds, no doubt principally, if not exclusively, foreign government bonds, desirably of relatively short-term maturities.

Thus, it would seem proper to consider such investments as falling into the category of assets, the value of which is defined in foreign currency units, or, using the terminology previously employed, as a money-value item. It must be recognized that the market value of temporary investment securities may be subject to fluctuations. However, if the security in question represented a proper choice for temporary investment purposes, e.g., substantial absence of risk created by the credit status of the issue, market value fluctuations would be limited to the result of the impact of

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[14]General Motors Corporation, Annual Report (1950).

changes in the prevailing applicable rate of interest on the fixed currency rights (receipt of interest and principal) contractually created by the security indenture. Over the relatively short period of time which is pertinent when considering temporary investments, fluctuations in interest rates will not typically be of substantial amplitude, and the effect of such movements in interest rates as do occur on the market value of short maturity securities will not be large. Hence, the possibility of market value movements, assuming proper selection of temporary investment securities, does not appear to be of sufficient significance to alter the previously expressed conclusion as to the money-value classification of this type of asset. Let us now turn to an examination of the effect of this conclusion on the specific procedures for translating temporary investments expressed in terms of foreign currency units into dollars.

As a basis for discussion, assume that a foreign subsidiary corporation acquired, as an investment of seasonally excess cash, short-term government bonds on November 1, at a cost of 5,000 foreign currency units. The rate of exchange on this date was five foreign currency units to one United States dollar. On December 31, when the accounts of the subsidiary are to be translated into dollars, the exchange rate is six foreign currency units to one United States dollar.

In the first place, let us assume that the market value of this investment has not changed from the cost of 5,000 currency units, at least in any substantial amount. Under these circumstances it would seem logical to translate this asset by applying the December 31 exchange rate of six to the 5,000 foreign currency unit cost (and at least approximate market value), resulting in a translated dollar value of $833. The use of the rate of exchange current on December 31, is in accord with the previous discussion of the proper valuation in dollars of foreign assets, the value of which is

defined in foreign currency units. It is important to point out that the shrinkage in dollar value of this investment from $1,000 on November 1 (5,000 foreign currency units divided by the exchange rate on that date of five foreign currency units to one United States dollar) to $833 on December 31, or a decrease of $167, represents a loss occasioned by the declining dollar value of the foreign currency. This is the type of loss or gain which should be included in the exchange adjustment or loss on exchange. As previously mentioned, the precise determination of gain or loss on exchange rate movements is one of the basic objectives of the translation procedures developed in this and the succeeding chapter.

The case discussed in the preceding paragraph, namely that in which cost and market value are substantially the same should, given proper selection of the temporary investment security, be the typical one. However, it is possible for substantial changes in market value to occur, even over the short period of time during which a temporary investment is held. Rapid deterioration in the credit status of the issuer of the security or a substantial increase in the applicable going rate of interest may occasion large declines in market quotations and a substantial decline in interest rates will produce market value movements in an upward direction. What, if any, recognition should be given to market value movements in connection with the translation of foreign currency accounts into dollars?

First, let us assume the facts as presented in the preceding example, with one modification, that the market value of the temporary investment had fallen from its cost on November 1, of 5,000 currency units to 4,500 currency units on December 31. It is likely that the foreign subsidiary will have adjusted the carrying value of the investment to the lower market value, since the use of lower of cost or market value may be fairly safely described

as conventional accounting procedure.[15] Again, given the nature of the asset in question, it seems logical to employ the December 31 exchange rate in the process of translation into dollars. This will produce a dollar valuation of $750 (4,500 ÷ 6). This amount represents a rational measure of the December 31 dollar value of the asset in question. In this situation, however, the objective of restricting the reported exchange gain or loss to the result of the change in the dollar value of the foreign currency demands recognition. The decline in dollar value from $1,000 on November 30, to $750 on December 31, or $250 cannot accurately be attributed to the change in the rate of exchange from five to six. Rather, it is a combination of two types of loss; that caused by decline in market value, and that caused by a lower dollar value of the foreign currency. Correct reporting requires a separation of these two losses, expressed in dollar amount, as follows. If the market value had not changed, as in the first case, a loss of $167 would have resulted from exchange rate movement. In this case, however, the decline in market value from 5,000 to 4,500 foreign currency units created an additional loss of $83. This may be measured by the difference between the dollar value when no change in current market value as compared with original cost occurred ($833) and the dollar value of the lower market value ($750). Or it can be calculated as the dollar loss measured in terms of six foreign currency units to one dollar of a decline of 500 foreign currency units in the market value of the investment ($500 ÷ 6). It is obvious that the position set forth advocates nothing new in terms of translation technique since translation of a substantially lower market value at the current rate of exchange is in accordance with conventional procedure. However, the separation of the result of the lower dollar value

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[15] This should certainly not be construed as an endorsement of the lower of cost or market "rule".

of the investment into its two component parts does represent an attempt at correct reporting of foreign operating results not yet recognized in current accounting practice.[16]

Finally, it is necessary to consider the case in which the current market value exceeds the original cost. Assume the December 31 market value is 5,700 foreign currency units. Conventional accounting procedure would insist upon ignoring the enhanced market value until it was realized in a subsequent accounting period by a sale at the higher market value. Hence, the translation of the original cost of 5,000 currency units at the current rate of six would produce the same results as the first case. Since it is not the purpose of this discussion to deal with the inadequacy or inconsistency of accounting principles in general (or the lower of cost or market principle in particular) the position just mentioned will be accepted with reservations. The author would much prefer to employ current market value consistently as a measure of the current money-value of temporary investments, a position which in the instant case would result in the recognition of a dollar value of $950. If this value is employed it would again be desirable to separate the $50 ($1,000 - $950) decline in dollar value into the loss occasioned by the lower dollar value of the foreign currency of $167 and the gain created by the increase in the market value of $117 ($700 ÷ 6). It must be recognized that the allocation of the decline in dollar value ($50) is influenced by the timing of the change in exchange rate and in market value. The results set forth above have assumed that the change in exchange rate occurred prior to the increase in market value to

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[16]This separation is similar to the distinction between trading and price level profits or losses which is found in many discussions related to the question of dealing with the effect of changing domestic prices.

$5,700. If the increase in market value took place while the exchange rate was five to one the loss in dollar value of $50 would be attributable to a market value gain of $140 ($700 ÷ 5) and an exchange rate loss of $190.

The length of the preceding discussion relative to the translation of temporary investments is certainly not in proportion to the importance of the problem either in terms of frequency of occurence or of dollar magnitudes involved. Rather it has been employed principally as a first attempt to set forth the sort of reasoning which should precede the decision as to the selection of appropriate procedure for the translation of specific items expressed in foreign currency. It particularly is intended to emphasize the necessity of clearly defining an asset item as to whether or not its value is directly expressed in terms of foreign currency units as a guide to selection of the appropriate rate of exchange (current vs. historical) and to present an initial exposure to the desirability of restricting exchange gain or loss to the results of changing dollar value of the foreign currency.

Receivables

The term "receivables" is obviously broad, embracing a wide variety of types of claims with varying maturities. For the purpose at hand, however, it is appropriate to consider as a homogeneous group all receivables which represent a claim for future receipt of a fixed number of units of foreign currency, regardless of the type of transaction giving rise to the claim or of the length of time which will elapse before collection of the claim will occur. All such receivables quite apparently represent assets which fit precisely into the category of money-value items, as that term has previously been employed. Hence, it is a logically necessary conclusion that all types of receivables, trade and non-trade, open book, notes receivable or accruals, of short or long maturity, should be translated into dollars by employing the rate of exchange in effect on the date as of which the translation is

being performed. This will produce a dollar figure which represents the best available measure of the dollar realizable value of such receivable. As previously mentioned a more perfect measure of realizable value would be produced by employing the exchange rate which is expected to prevail on the date when the particular receivable will be converted into cash, and to apply an appropriate discount rate to the resulting amount in order to express it in present terms. However, the undesirability of attempting to project the future course of exchange rates necessitates the use of the known presently effective rate as the best available objective datum.

If it is desired to avoid altering the original dollar value of long-term receivables, a separate contra or adjunct account might be employed to reflect the alteration of original dollar value caused by exchange rate movements.

If valuation reserves or allowances have been recorded on the records of the foreign subsidiary in order to reflect the best available estimate of the portion of the gross receivables which will not be converted into foreign cash because of uncollectibility, such reserve or allowance accounts should be translated at the current rate of exchange. This will result in the net estimated realizable value, expressed in foreign currency, being translated into dollars at the current exchange rate.

Inventories

For the purpose of this discussion the term "inventories" will be employed in a sense somewhat different than the ordinary accounting connotation of the term. As was the case in the immediately preceding section, our objective at this point is to deal with asset items which have common characteristics in terms of the immediate problem, that of developing rational procedures for translation of items expressed in foreign currency into dollars. Hence, in the discussion which follows the term "inventories" will

be considered to include all elements of cost incurred but not yet consumed or expired, but which, in the normal course of operations, will be consumed in a relatively short period of time. From this point of view it follows that this section will apply not only to stocks of merchandise, raw material, partially completed or fully completed product, but also with all items commonly described as prepaid expenses, whether or not such items are of a tangible or physical nature.

It will be recalled that in connection with the asset items considered thus far, the conclusions reached in this discussion as to the procedure of translating foreign currency balances did not take serious issue with what may be somewhat loosely described as conventional procedure. Since this is not the case with the items under examination at this point, it is appropriate to survey current practice in this connection briefly. It is a reasonably safe generalization to state that textbook material on the subject of foreign exchange uniformly suggest the translation of inventories into dollars by applying to the inventory account or accounts, as shown by the records of the foreign subsidiary, the rate of exchange in effect on the date as of which the translation is being made.[17] The position of the American Institute of Accountants is set forth in the following statement:

> Inventory should follow the standard rule of market or cost, whichever is lower in dollars. When accounts are to be stated in which the question of foreign exchange enters and the inventory is not treated as an ordinary current asset and converted at the rate of exchange prevailing on the date of the balance sheet, the burden of proof should be on the client.[18]

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[17] G. H. Newlove, C. A. Smith, and J. A. White, Intermediate Accounting, (Boston: D. C. Heath and Company, 1948). This book represents a conspicuous contrast to most American textbook material in this area, largely due to the substantial use of reference to British works on foreign currency accounting methods.

[18] American Institute of Accountants-Committee on Accounting Procedure, op. cit., pp. 34-35.

This statement is followed by a paragraph dealing with possible deviations from the use of the current rate, which will be referred to later in this section.

As the preceding paragraph indicates, prevailing American practice is to follow the current-fixed classification and to include inventories with other current asset items (cash, receivables, etc.) in the selection of appropriate translation procedure. It seems abundantly clear that this position is in error, by reason of a failure to recognize the distinct difference between inventories (including expense prepayments) and other current assets (cash, marketable securities, and receivables). As has been previously pointed out cash, marketable securities, and receivables are assets, the value of which is measurable in terms of a contractually determinable number of foreign currency units. This is certainly not the case with inventories. While it is true that the fundamental source of value in any asset item is its potential cash receipt producing ability, the magnitude of such potential cash receipts attributable to inventories is typically not precisely determinable. As a result, traditional procedure resorts to past outlay as the most satisfactory measure of inventory value, modified, of course, where sufficient evidence is available to indicate clearly that present or future events render past outlay unsatisfactory as a reasonable measure of value. It will be the contention of this discussion that the procedure of translating foreign inventories into dollars should be consistent with the nature of the item involved, which logically leads to rejection of the arbitrary application of the current exchange rate in the process of translating inventory accounts. Instead, the use of exchange rates which will produce the equivalent of the original dollar cost will be advocated as the most rational procedure.

Turning now to the specific techniques to be employed in the translation of inventory and related items, it seems necessary to proceed in terms

of two rather distinct classifications. In the first place, there may exist stocks of merchandise, raw materials or partly or fully completed products which were originally acquired or manufactured in the United States and which therefore have a readily ascertainable dollar cost. On the other hand, we may be confronted with inventory items the original cost of which was incurred in foreign currency.

In connection with the first category, published financial statements indicate a fairly general use of the method of translating dollar cost inventory items at such original dollar cost. Information relative to the dollar cost of such goods will ordinarily be readily available in the records of the domestic parent company. In the event the dollar replacement cost of domestic origin inventories has declined since the date of shipment to the foreign subsidiary and it is desired to employ the lower of cost or market technique, the adjustment from original dollar cost should be reflected in a separate loss account in order to avoid merging trading and price fluctuation losses. The translation of dollar origin inventories at the exchange rate in effect as of the date of the translation does not represent satisfactory procedure as a brief example will serve to illustrate. Assume that merchandise which cost the domestic parent $4,000 was shipped to a foreign subsidiary when the exchange rate was five foreign currency units to one dollar, and hence was recorded by the subsidiary at 20,000 currency units. If this entire shipment was unsold by the subsidiary on its closing date, when the exchange rate was four foreign currency units to one dollar, the use of the current exchange rate would result in a dollar valuation of $5,000, an upward adjustment of $1,000. Currently accepted accounting procedure would not approve this assignment of a value in excess of original cost to unsold inventory. The opposite sort of dollar value adjustment would result in a case in which the dollar value of the foreign currency depreciated. As

an extreme example, assume the exchange rate in the preceding illustration had advanced to eight units of foreign currency to one dollar by the subsidiary's closing date. Use of this rate would produce a dollar valuation of $2,500 or a downward adjustment of $1,500. It is extremely doubtful if this adjustment is related to either a reduced net realizable value in foreign currency or to a reduced replacement cost in dollars. It is impossible to escape the conclusion that, given the nature of asset items included in the term inventories in this discussion, the arbitrary use of current exchange rates in the translation process will produce indefensible results. Translation of dollar origin inventories should be in terms of the original dollar cost, with possible adjustment to a lower dollar replacement cost if desired, in order to satisfactorily remain within the framework of currently accepted accounting principles.

When we turn our attention to the problem of translating inventory items of foreign origin the typical procedure, as observed in published financial statements, differs sharply from that described above. In this situation, inventory items are most commonly considered as being a part of the general current asset category and are translated at the rate of exchange effective as of the date of translation. It will be recalled that this represents the basic recommendation of the American Institute of Accountants and is certainly the predominant position taken by American textbooks dealing with the subject. It is the position of this discussion that, so long as original cost is retained as the fundamental inventory valuation principle and since in no way do inventory items represent a contractual claim to a fixed number of units of foreign currency, the use of the current exchange rate for purposes of translating such assets into dollars is not logically defensible. In fact, there would seem to be no reason to depart from the conclusions expressed in the case of dollar origin inventory items. This would require the translation of inventory items which were originally

acquired in foreign currency at the exchange rate in effect on the date on which such inventories were acquired. This is the only procedure which will result in the reporting of the equivalent dollar cost of material, merchandise, or other costs, whether expired and hence includible in expense classifications or unexpired and therefore properly reflected in the balance sheet. As illustrated in the preceding section dealing with dollar origin inventories, the use of the current rate of exchange will result in upward or downward adjustments of the equivalent original dollar cost of a completely arbitrary nature with no necessary relation to movements of replacement cost or net realizable value.

The position set forth in the preceding paragraph deals with the situation in which the desire (or policy) of the enterprises involved is to employ original cost as the inventory valuation method, without recognition of changes in replacement cost or net realizable value. Unfortunately, we are presently confronted by a reasonably general acceptance of the point of view that "inventory should follow the standard rule of market or cost, whichever is lower in dollars."[19] Hence, it is necessary to examine briefly the effect of changes in replacement cost (or net realizable value) in combination with movements in exchange rates. As a basis for discussion, assume that a foreign subsidiary acquired a lot of merchandise at a cost of 30,000 foreign currency units at a time when the rate of exchange was ten foreign currency units to one dollar. Thus, the equivalent dollar cost of this merchandise is $3,000, a fact which cannot be changed by movements in exchange rates or replacement cost. The problem at hand, however, is what recognition should be given to changes in either of these variables in the event that "lower of cost or market" is to be employed. It seems essential to insist

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[19] American Institute of Accountants-Research Department, op. cit., pp. 2-3.

that the original equivalent dollar cost ($3,000) must be the starting point and that departure from this amount can be sanctioned (under presently accepted accounting techniques) only when events occurring subsequent to the purchase of this merchandise render the equivalent original dollar cost an unreasonably high valuation. For the purpose of this discussion it will be maintained that estimated net realizable value in foreign currency is the most rational basis for downward adjustments in the original equivalent dollar cost. The use of replacement cost or "market" is, in fact, only an attempt to substitute a reasonably objective amount for the more evasive net realizable value concept. The immediate impact of this position is apparent. When net realizable value is adopted it is necessary to consider inventories as taking on the characteristics of money-value items, the value of which is a reflection of specific future cash inflows, and hence to bring the current rate of exchange into the translation process. This is the only situation, however, in which the current exchange rate is significant in the translation of inventory items, and its use in the illustrations which follow must not be interpreted as a sanction of the acceptability of the arbitrary application of the current exchange rate to original foreign currency cost. It is apparent that there are innumerable possible combinations of changes in exchange rates and movements in net realizable value. In the interest of restricting this discussion to a reasonable length, the illustrations presented will be limited to two involving an upward movement of exchange rates between purchase and translation date and two involving movements of exchange rates in the opposite direction. Each of the two fundamental situations will be subdivided into cases in which net realizable value is above and below original dollar cost.

As a basis for each of the illustrative situations which follow, assume the acquisition by a foreign subsidiary of goods costing 15,000 foreign

currency units on a date when the rate of exchange was ten foreign currency units to one dollar. Hence, the equivalent original dollar cost in all cases is $1,500, which would be the appropriate amount at which the inventory would be stated in dollars if no consideration is given to net realizable value (or replacement cost) on the date of the translation, regardless of the exchange rate in effect on that date.

The illustrative situations set forth below are presented with a dual objective: (1) to establish logical criteria for the translation of inventory values when complete allegiance to the original cost basis is abandoned and recognition is to be given to changes in net realizable value occurring subsequent to the date of purchase, and (2) to point out the possibility, and in the opinion of the writer, desirability of separating the difference between original dollar cost and translated balance sheet date value into the two component parts thereof, namely, the result of changes in net realizable value and the result of movements in exchange rates.

Let us first assume that the lot of goods described above is still intact in the inventory of the subsidiary on its closing date and that the exchange rate on this date is fifteen foreign currency units to one dollar as compared to the ten to one relationship existing on the date of purchase. If the net realizable value of the goods, expressed in foreign currency units, had decreased to 10,000 on the closing date and it was desired to give recognition to this event, it would be appropriate to translate this inventory value into dollars by applying the current exchange rate of fifteen to one to the current net realizable value (10,000 currency units) giving a translated dollar value of $667. As was previously stated, the use of the current rate of exchange in this situation is justified by the fact that it is being applied to the net realizable value of the goods rather than the original cost. Translation to a dollar value of $667 indicates a reduction in value

as compared with original dollar cost ($1,500) of $833. It is next appropriate to determine the cause of this reduction in value, which may be done with adequate accuracy as shown in the following schedule:[20]

Decrease caused by decline in net realizable value:		
5,000 foreign currency units translated at an exchange rate of 15 to 1		$333
Decrease caused by change in exchange rate:		
Value of original investment of 15,000 foreign currency units:		
At original 10 to 1 rate	$1,500	
At current 15 to 1 rate	1,000	
Decrease		500
Total decrease		$833

While the above analysis is perhaps of more theoretical interest than of practical importance, it would appear that the division of the total change in value is significant from the point of view of the assignment of responsibility for the operating results of a foreign subsidiary. While neither changes in net realizable value nor changes in exchange rates are susceptible to control by the management of an individual enterprise, there seems little question but what the change in net realizable value of stocks of goods is more controllable in terms of purchasing and selling policies than the effect of exchange rate fluctuations. Regardless of whether any significance is attached to the allocation of the decrease in value of $833, it seems essential that the inventory should be valued at the original cost of $1,500 for purposes of computing cost of goods sold and hence the profit from "trading" activities, with the decline in value of $833 being reported as a separate item (or items) in the computation of total net income. The same comment regarding the effect on the results of

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[20] It should be recognized that a more refined analysis could be prepared which would give separate recognition to the effect upon inventory value of the combined effect of change in exchange rates and change in net realizable value.

this analysis of various assumptions regarding the timing of exchange rate and realizable value changes as was made in connection with marketable securities is appropriate at this point. The preceding analysis assumed that the change in exchange rates occurred first. If this sequence is reversed the amounts attributable to realizable value and exchange rate changes will be reversed. This is equally true in relation to the illustrations which follow.

If the preceding case is modified to the extent of assuming an increase in net realizable value to 20,000 foreign currency units in place of a decrease to 10,000, with no change in the assumption regarding the movement of exchange rates, the following results would obtain. The current net realizable value of 20,000 currency units should be converted at the current exchange rate of fifteen foreign currency units to one dollar, producing a dollar value of $1,333. As compared with the original dollar cost of $1,500 this indicates a decrease in dollar value of $167 which may be analyzed as to cause as follows:

Decrease caused by change in exchange rate:		
Value of original investment of 15,000 foreign currency units:		
At original 10 to 1 rate	$1,500	
At current 15 to 1 rate	1,000	$500
Increase caused by increase in net realizable value:		
5,000 foreign currency units translated at an exchange rate of 15 to 1		333
Net decrease		$167

As in the preceding case, a dollar valuation of $1,500 should be assigned to this lot of goods for the purpose of computing cost of goods sold with the decline of $167 in dollar value reported separately.

Let us now turn to a pair of illustrations in which the exchange rate moved in the opposite direction from that in the preceding cases between the date of purchase and the date on which the translation into

dollars is being performed. Assume the same facts regarding original currency and dollar cost and the closing date net realizable value as in the first illustration, but instead of the foreign currency depreciating in value in terms of dollars, assume a movement from ten currency units to one dollar to a rate of six currency units to one dollar. Under these circumstances the translation into dollars would produce a valuation of $1,667, resulting from the application of the current rate of exchange (6 to 1) to the current net realizable value of 10,000 foreign currency units. This dollar value indicates an increase in the domestic value of this lot of goods of $167, which, within the confines of presently accepted conventions regarding the recognition of unrealized gains, should not be recognized. In this case, it seems particularly significant, however, to inquire as to the specific factors responsible for the change in dollar value between the date of purchase and the date of translation. Reference to the total dollar values involved, e.g., $1,500 and $1,667 indicates at least satisfactory discharge of managerial responsibilities within the foreign subsidiary. Closer scrutiny of the causes of the movement of value produces some reason for modification of the abovementioned point of view, as shown in the following tabulation:

Increase caused by change in exchange rates:		
Value of original investment of 15,000 foreign currency units:		
At current 6 to 1 rate	$2,500	
At original 10 to 1 rate	1,500	$1,000
Decrease caused by decline in net realizable value:		
5,000 foreign currency units translated at an exchange rate of 6 to 1		833
Net increase		$ 167

This tabulation shows that the entire increase in value is attributable to

the increase in the dollar value of the foreign currency between the date of purchase and the date of translation. There is little, if any, reason to believe that this is a factor which is subject to control by the management of the individual enterprise. On the other hand, the decline in net realizable value of the particular goods in question accounted for a decrease in dollar value of $833. It seems reasonable to conclude that managerial action may have considerably more influence in this area, stemming from the impact of purchasing and sales policies. It must be recognized, however, that the decrease in net realizable value may well have resulted from a fall in the general price level in the country in which the foreign subsidiary is domiciled rather than a decline in the relative value of the specific goods in question. Under these circumstances, the movement in net realizable value is akin to the movement of exchange rates in terms of the possible impact thereon of the action of the individual enterprise.

To complete the exploration of this area, let us modify the immediately preceding case by assuming an upward movement of net realizable value from original cost of 15,000 foreign currency units to a current net realizable value of 20,000 currency units, with all other facts remaining unchanged. Under these circumstances the goods in question should be valued in dollars by applying the current exchange rate of six foreign currency units to one dollar to the current net realizable value of 20,000 foreign currency units, producing a dollar valuation of $3,333. Since this amount exceeds original dollar cost by $1,833, the original dollar cost of $1,500 would be the appropriate amount to be employed. As has been demonstrated in the three preceding cases the increase of $1,833 in dollar value is caused by two factors, the change in net realizable value and the change in exchange rates. In this case the impact of these two factors may be calculated as follows:

Increase caused by increase in net realizable value:		
5,000 foreign currency units translated at an exchange rate of 6 to 1		$ 833
Increase caused by change in exchange rates:		
Value of original investment of 15,000 foreign currency units:		
At current 6 to 1 rate	$2,500	
At original 10 to 1 rate	1,500	1,000
Total increase		$1,833

The preceding discussion relating to the translation of inventory costs has, at least for illustrative purposes, employed a lot or batch of merchandise (or raw materials), the original cost of which was determined by a so-called specific identification technique. The use of other available methods or assumptions for determining the acquisition date and hence original cost of inventory items would in general have no affect on the application of the principles set forth above. The only possible exception would occur under the use of the last-in, first-out method, when the lifo acquisition date was earlier than the date upon which the shares of the foreign subsidiary were acquired. Under these circumstances the exchange rate in effect on the date on which the shares of the subsidiary were acquired would be substituted for the exchange rate in effect on the date on which the goods in question were assumed to have been acquired. This point is discussed more fully in the section of this chapter dealing with the translation of fixed assets.

It is also appropriate to indicate that, although the illustrative cases previously employed dealt with the translation of a lot of merchandise or raw materials, the application of the same principles to the translation of work in process or finished product is not only possible but desirable. Any reasonably well designed and operated cost accounting system should provide the information necessary to determine the date of

the original outlay for the cost components of partially or fully completed product. The application of the exchange rates in effect on the date of the respective cost outlays will result in the expression of work in process or finished goods inventories in terms of equivalent original dollar cost. If it is considered appropriate in particular circumstances to depart from original cost, the use of estimated net realizable value represents the most satisfactory alternative, and as was previously indicated, the rate of exchange in effect on the date of translation would then be appropriately employed in the translation process.

Fixed Assets

The term "fixed assets", as used in the discussion which follows is intended to include long-lived assets used in the day-to-day operations of the foreign subsidiary, whether possessing tangible physical existence or of an intangible nature.

It will be recalled that earlier in this chapter it was indicated that the translation procedures which are recommended in this discussion are founded upon the objective of achieving an expression of foreign asset and liability values consistent with "generally accepted" valuation criteria as applied to domestic assets and liabilities. In this connection, it was stated that the appropriate valuation method for fixed assets was original cost less the portion thereof recognized as having been consumed through use or the passage of time (depreciation or amortization). The application of this criterion to the translation of fixed assets leads to the conclusion that the proper translation procedure for foreign fixed assets is to apply to the original cost in foreign currency units the exchange rate in effect when such original cost was incurred. This will produce the equivalent dollar cost as of the date of original acquisition. This suggestion is in line with the earlier contention that the most

rational translation procedure requires the application of a current rate of exchange to the foreign currency balance of assets and liabilities which may be characterized as money-value items, and the use of acquisition date exchange rates in connection with real or non-money-value assets. It seems clear that long-lived tangible and intangible assets are definitely within the area of non-money-value items.

The translation of accumulated reserves or allowances for depreciation or amortization of the cost of long-lived assets should be handled in a manner consistent with the translation of the cost thereof. Thus, the appropriate depreciation rate should be applied to the translated dollar cost of the depreciating asset. If the foreign subsidiary has employed appropriate rates of depreciation the same result may be accomplished by expressing the depreciation allowance in dollars at the same proportion of the dollar cost as the foreign currency allowance is of the foreign currency cost.

In general the procedures outlined above are in accordance with traditional techniques, as set forth in textbook material and in the pronouncements of professional societies. Thus, the Special Committee on Accounting Procedure of the American Institute of Accountants in a memorandum devoted to a consideration of the problems of foreign exchange, issued in December, 1931, and reprinted in subsequent bulletins on the subject in December, 1933, December, 1939, and November, 1949, stated:

> Fixed assets should be converted into dollars at the rate prevailing when such assets were acquired or constructed. Where large units are purchased for American dollars the American dollar cost will, of course, be used. If, however, the purchase is made in some foreign currency then the cost of the fixed asset should be the equivalent of the amount of foreign currency in American dollars, at the rates of exchange prevailing at the time payment is made. In consolidated accounts, the depreciation charged on fixed assets should be kept strictly on the American dollar cost, even though for

purposes of local taxation it may be impossible to show the full foreign currency equivalent on the foreign statements.[21]

The possibility of departing from the procedures set forth in the preceding paragraph under special circumstances was mentioned in a statement issued by the Research Department of the American Institute of Accountants in November, 1949.[22] This statement was issued as a result of the accounting problems raised by the substantial devaluation in terms of American dollars, of the currencies of a large number of foreign countries during 1949. As a corollary of the suggestion that it might be appropriate to restate long-term debt in terms of post devaluation rates, it is stated "....when fixed assets held in the foreign country were acquired with funds obtained in that country, it may be appropriate to restate the fixed assets to the extent of the reduction in the related debt." It will be noted that this suggestion applies only in situations in which a substantial currency devaluation has occurred. As will be set forth below and amplified in a later chapter, it is the feeling of the writer that a substantial currency devaluation calls for a rather general adjustment of foreign asset and liability values (expressed in dollars).

Having examined the fundamental principle governing the translation of long-lived assets and the related reserves or allowances for depreciation or amortization, it is appropriate to turn to an examination of several special situations which justify departure from the methods suggested above.

The first special situation meriting mention is that which exists when a domestic parent corporation acquires all or a substantial part of

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[21]American Institute of Accountants-Research Department, op. cit., p. 2.

[22]Ibid., p. 6.

the voting shares of a foreign subsidiary on a date subsequent to that on which the subsidiary was organized and began operations. In this situation it is likely that a problem may arise in connection with the selection of the appropriate exchange rate to employ in the translation of fixed assets. Should the exchange rate in effect when the foreign subsidiary acquired its original complement of fixed equipment be employed, or is the rate in effect when the parent company later acquired the shares of the subsidiary the more appropriate? In the opinion of the writer, the latter rate is preferred. This reflects the point of view that the acquisition of all or a substantial part of the shares of a corporation is a major event in the financial history of a corporate entity and the consideration involved in the acquisition transaction may even be used as the basis for adjusting net asset values as reflected by the records of the acquired entity. Certainly from the point of view of the acquiring entity it is the equivalent dollar value on the date of acquisition which is significant in comparison with the dollar cost of the investment. It is apparent that this problem will exist only in the case of fixed assets and (to a substantially lesser degree) inventories, in other words in the case of real value assets where the acquisition date rate retains significance after the date of acquisition.

Another situation justifying departure from the basic translation principle set forth above exists in the case of a substantial and abrupt devaluation in terms of dollars of a foreign currency. Reference was previously made to the position of the American Institute of Accountants in this connection, which, it will be recalled was in essence that under certain circumstances it <u>may</u> be appropriate to restate fixed asset values in recognition of the altered dollar value of the foreign currency. Although detailed consideration of the problems created by devaluation of a foreign currency is deferred until Chapter IV, it is appropriate to briefly mention

at this point the position of the writer on this subject. In substance, an abrupt, substantial and, to all appearances, permanent change in the dollar value of a foreign currency is much the same as a comparable change in the economic significance of our domestic monetary unit, the dollar. If by means of an executive decree, the "value" of the dollar was cut in half and as a result the number of dollars relating to all contracts and other legal instruments was doubled, there would seem to be little doubt that accountants would advocate a complete restatement of the dollar amounts contained in accounting records to give realistic recognition to the altered economic significance of the new, as compared to the old, monetary unit. The devaluation of a foreign currency unit, in terms of its dollar value creates a new foreign currency unit (in terms of dollars) and justifies adjustment of the dollar value of all foreign asset, liability, and net worth accounts in order that they may be expressed in terms of the dollar equivalent of the "new" foreign currency unit. From the date of the devaluation forward the exchange rate in effect immediately following the devaluation becomes the acquisition rate for purposes of the translation of fixed asset items.

A third special situation may exist when, pursuant to local profits tax regulations, the fixed asset and related depreciation and amortization allowances have been restated to give recognition to substantial changes in the foreign internal price level. Thus, France allows the restatement of fixed asset and related allowance for depreciation accounts, with depreciation allowable as a deduction for tax purposes being computed by spreading the adjusted net book value over the remaining estimated service life.[23] If the foreign accounts have been altered to give recognition to

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[23] J. William Davis, "France Shows How to Revise Accounts to Accomodate Inflation Without the Controls Found in Hungary", Journal of Accountancy, August, 1951, pp. 196-7.

such price level adjustments, it is essential that the fixed asset accounts be restated in terms of original currency cost before applying the appropriate exchange rate in the translation process. While such adjustments are quite appropriate for the purpose of computing taxable income, the adjusted fixed asset values do not provide an appropriate base for the purpose of translating foreign balances into their dollar equivalents.

A final problem, which is perhaps more interesting than important, relates to the possible depreciation in dollar value of funds being held by a foreign subsidiary pending the expenditure thereof for capital asset items. If $10,000 is advanced to a foreign subsidiary by the domestic parent company for the purpose of the purchase by the foreign subsidiary of a tract of land for plant expansion purposes, what treatment should be accorded the loss or gain in the dollar value of these funds resulting from change in the exchange rate pending their expenditure? For example, if the exchange rate were ten foreign currency units to one dollar when the funds were transmitted and fifteen foreign currency units to one dollar at the time the funds were expended by the subsidiary for the land, how should the exchange loss of $3,333 be treated? The cost of the land, employing the procedures previously outlined, would be $6,667 (100,000 foreign currency units x 1/15). However, the dollar outlay by the parent company was $10,000, which would seem to indicate that the exchange loss during the period while the funds were held pending the purchase of the land should be considered as a part of the cost of the land. On the other hand, it may be maintained that the exchange loss in this situation is no different from any such loss on net-money-value assets and should be considered as a factor in calculating the over-all net income of the subsidiary for the period during which these transactions occurred. The exchange loss suffered during the period preceding the purchase of the land does not add

to the value of the land in any sort of economic sense and should not be included in the equivalent dollar cost of the land, but rather should be considered as a loss to be charged against revenue of the period in which it occurs. A contrary argument which would support capitalization of losses on money-value assets held for the purpose of acquiring long-lived assets would consider such losses similar to costs of the period during which fixed assets are being constructed. The analogy does not hold up under closer scrutiny, however. Pre-operating costs are recognized when a capital expenditure is contemplated and unless the resulting property unit will have utility at least equal to these costs and all other costs of acquisition the property unit will not be constructed. It seems doubtful if exchange losses of the type being considered at this point are similarly included in the cost factors which are given recognition in the course of reaching a decision regarding a construction project. Rather, such losses are more akin to a loss caused by a fire or other catastrophe to a construction project, and it seems very doubtful if capitalization of this type of loss should be considered appropriate. A similar problem may be created by changes in the dollar value of short-term liabilities related to the acquisition of fixed assets, and a parallel solution is appropriate.

In summary, the appropriate translation procedure to employ in connection with long-lived assets and related reserves is to translate the original currency cost at the exchange rate in effect when such currency cost was incurred, thus producing the equivalent dollar original cost. If the original cost was incurred in dollars in the first place, this original dollar cost represents the appropriate dollar valuation to employ. Departure from this fundamental rule may be appropriate under special circumstances, as outlined above, particularly when a substantial

and sudden change in the dollar value of the foreign currency unit has occurred.

Current Liabilities

The subject of the appropriate procedures to employ in the translation of short-term debts of a foreign subsidiary can be disposed of very briefly. It is apparent that current liabilities clearly fall within the category of an item the value of which is definitely measurable in terms of a specific number of foreign currency units. Hence, it is logical to express such foreign currency liabilities in dollars by applying the exchange rate in effect on the date of the translation to the foreign currency value of the debt. Ideally, such obligations should be translated at the rate which will be in effect when the liability will be liquidated, but in the absence of the ability to predict the future course of movements in exchange rates with any sort of accuracy, the current rate represents the most satisfactory compromise. This recommendation is in agreement with traditional translation procedures, and hence no extended discussion appears necessary.

Long-term Liabilities

Before setting forth recommendations relative to the translation of long-term debt, payable in foreign currency units, it is appropriate to survey the procedures which have been traditionally recommended in this connection. Typical textbook treatment of the subject is indicated by the following statement, which indicates that long-term liabilities should be translated ".....at the rate prevailing when the liability was contracted."[24] The original position of the American Institute of Accountants, as set forth in the December, 1931 memorandum of the Special Committee on Accounting Procedure, was:

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[24]Finney and Miller, op. cit., p. 596.

> Long-term liabilities should not be converted at the closing rate, but at the rate of exchange prevailing when the liability was actually contracted. This is a general rule, but exceptions might exist in particular cases: for example, where there are assets receivable over a term of years, which are converted at the current rate, particularly where such assets could be applied to the retirement of such liabilities.[25]

The possibility of departure from this "general rule" was mentioned in the statement of the Research Department of the American Institute of Accountants dealing with special problems associated with the devaluation of foreign currencies, which stated:

> Translation of long-term liabilities presents possibly the greatest deviation from the principles previously stated by the committee. The committee generally has favored translating long-term liabilities at the rates of exchange prevailing when the liability was actually contracted, but recognized that there were exceptions. The purpose was to avoid giving recognition to minor fluctuations in foreign currencies. The argument has been advanced, however, and apparently without satisfactory rebuttal, that long-term bonds will be paid off in post-devaluation currencies and therefore should be translated at post-devaluation rates. This argument may not be compelling in any given instance, but the logic supporting it is convincing for a fall in rates of the breadth and size of the one just witnessed. Accordingly, with respect to long-term bonds, the general rule should be modified to permit translation at post-devaluation rates.
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> Under certain circumstances, the gain resulting from restating long-term debt at the lower rates of exchange may appropriately be offset against the loss arising from translation of net current assets. However, when fixed assets held in the foreign country were acquired with funds obtained in that country, it may be appropriate to restate the fixed assets to the extent of the reduction in the related debt.[26]

This statement is interesting in that it represents perhaps the first authoritative indication of the possibility of departure from the traditional "rule" that current assets and liabilities should be translated at the current rate regardless of their form and fixed assets and liabilities at the acquisition or incurrence date rate.

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[25]American Institute of Accountants-Committee on Accounting Procedure, op. cit., p. 35.

[26]American Institute of Accountants-Research Department, op. cit., pp. 6-7.

It is readily apparent that long-term debt, regardless of the maturity thereof, represents an item the value of which is clearly and contractually defined in terms of a specific number of foreign currency units, and hence, as indicated by the general principles set forth earlier in this chapter, translation at the rate of exchange current at the date of the translation represents the only rational procedure. It does not seem to be appropriate to employ, in the translation process, an exchange rate which is no longer meaningful and in fact is likely to be misleading, merely to avoid the necessity of altering, from year to year, the dollar value of foreign long-term debt. On the other hand the changing value of such debt in terms of dollars would seem to be a very significant piece of financial information, particularly in terms of evaluating the wisdom of the choice of a particular method of obtaining funds with which to carry on foreign operations. In essence, the use of the current rate in this connection does not represent any substantial departure from traditional procedure, since it results in the translation of the present value of such debt at the presently existing rates. If long-term bonds were issued at par, this par value represents the present value. If the original issuance involved a premium or discount, the present value at any date is measured by the difference between par value and the unamortized premium or discount at that date, and it is to this amount that the current rate should be applied.

Examination of a number of published annual reports disclosed only one case in which the recommendations set forth above were apparently followed. The following footnote was appended to a balance sheet of foreign subsidiaries of Standard Brands, Incorporated at November 30, 1951:

> Current assets, current liabilities, serial debentures, and deferred charges in foreign countries have been translated from foreign currencies into U.S. dollars at rates of exchange as of November 30, 1951, and 1950.[27]

The serial debentures were payable in Canadian dollars and the fact that there was no change in the U. S. dollar liability as shown on the November 30, 1950, and 1951 balance sheets would seem to indicate that Canadian dollars were treated as the equivalent of United States dollars, although no information in this connection is given in the report.

In summary, it is the contention of the writer that all debts, regardless of the maturity thereof, should be translated from foreign currency to United States dollars by use of the exchange rate in effect on the date of the translation. Only by the use of this method does a realistic presentation of the equivalent dollar liability emerge. The gain or loss resulting from altered dollar value of short- or long-term debts is a gain or loss to be included in the computation of net earnings of the foreign subsidiary for the period during which such gain or loss occurred.

Capital Stock-Common

It is generally recognized that the appropriate procedure for the translation of the common stock account of a foreign subsidiary is to employ the rate in effect when the stock was issued. If there have been several issuances this will involve translating the individual increments at their respective issuance date rates. The effect of this procedure is to produce an amount, expressed in dollars, which represents the equivalent dollar contributed capital of the foreign subsidiary. By and large this procedure is in agreement with the fundamental translation principles

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[27]Standard Brands, Incorporated, Annual Report (1951).

previously set forth. The common stock equity in a corporation, representing the residual equity in the net assets, can in no way, in a going concern, be construed to represent a money-value item.

The possibility of departing from the general rule of the use of issuance date rates is indicated by the following statement by the Research Department of the American Institute of Accountants:

> Consideration also should be given to the rates at which capital stocks stated in foreign currencies are to be translated; whether they should be translated at historical rates, or at the average of rates applicable to the net assets, or at the post-devaluation rates, would depend on the circumstances in the individual cases.[28]

In the opinion of the writer there are two principal circumstances in which departure from the use of issuance date rates is appropriate, both of which have been previously discussed in connection with the translation of fixed assets. If the domestic parent company acquired its investment in the shares of the foreign subsidiary at a date subsequent to that on which the shares of the subsidiary were originally issued, the exchange rate in effect on the date on which the parent company acquired the shares of the subsidiary should be substituted for the issuance date rate. In the event of a substantial and abrupt devaluation of the foreign currency, it is appropriate to substitute the rate in effect immediately following the devaluation for the issuance date rate.

Capital Stock-Preferred

Although the existence of preferred shares in a foreign subsidiary does not appear to be a common situation, at least passing attention to the problem of translating such shares is merited. There are many who feel that preferred stock possesses the characteristics of a money-value item, the money-value being the present value of a perpetual annuity of

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[28]American Institute of Accountants-Research Department, op. cit., p. 7.

the fixed annual dividend. Under this point of view the use of the current rate of exchange to translate the foreign currency value of preferred stock into dollars would be appropriate. While there is unquestionable logic in this position, it is the feeling of the writer that, in a going concern, preferred stock is nearer in substance to the common stock equity than to debt, and hence the same translation procedure should be employed in connection with preferred stock as was recommended in the case of common stock.

Surplus-Paid-In

Since paid-in surplus represents paid-in capital not assigned for the purpose of an accounting entry to the capital stock account, the same translation procedure as is employed in connection with capital stock is appropriate here, namely the use of the exchange rate in effect when the paid-in surplus was created.

Surplus-Reserves

Reserves representing appropriations of retained earnings should be translated into dollars by applying to the reserve balance as stated in foreign currency, the exchange rate in effect on the date on which the reserve was created. This sort of reserve is in no sense a liability and hence the use of the current exchange rate is not appropriate.

Surplus-Retained Earnings

The translation of retained earnings may be approached in either of two directions. Quite apparently, the balance of retained earnings, expressed in dollars must, by operation of the fundamental accounting equation be equal to the excess of foreign net assets expressed in dollars over dollar contributed capital. This amount is also equal to the excess of foreign earnings, expressed in dollars, over the dollar equivalent of distributions of such earnings in the form of dividends and the dollar equivalent of appropriations of retained earnings. The problem of trans-

lating foreign earnings and dividends will be examined in detail in the succeeding chapter at which point the derivation of dollar retained earnings will be examined in more detail.

Summary

In this chapter the necessity for the translation of the accounts of a foreign subsidiary from the foreign currency units in which such accounts are initially expressed to United States dollars has been pointed out. In addition, certain circumstances in which translation is inappropriate have been examined.

The major objective of this chapter has been to examine the appropriate procedures to be applied in the translation of specific asset, liability, and net worth accounts. In this connection, the most important feature of the discussion has been the suggestion that it is essential to abandon the conventional current versus fixed asset or liability classification in relation to the choice of the appropriate rate of exchange to employ in the translation process. Rather, the division of assets and liabilities as between those which are expressed in terms of a specific number of foreign currency units and those which are not, is productive of more rational results in the translation process. The use of the rate of exchange in effect on the date of the translation in the case of "currency" or money-value items and the acquisition date rate in the case of "real" value items is believed to be productive of the most informative dollar values. Having accepted the realism of this classification, the selection of the appropriate rate of exchange to employ in the translation of a particular asset or liability item is a simple matter. Cash and all claims to cash, regardless of maturity, should be translated at the current rate as should all debts, regardless of maturity. This will result in the valuation of such assets and liabilities at their realizable or liquidating

(in the case of liabilities) value, expressed in dollars of the date of the translation. Inventories, prepaid expenses, and long-lived assets, both tangible and intangible, should be translated by use of the acquisition date rate, thereby producing the equivalent original dollar cost. Paid-in capital should be expressed in dollars by application of the exchange rate in effect on the date of investment, thereby producing the equivalent dollar investment. Retained earnings, expressed in dollars, is the excess of accumulated earnings over distributions thereof, both expressed in dollars.

Departure from these basic translation criteria may be justified in at least two situations. In the event the domestic parent company acquires its investment in the foreign subsidiary on a date subsequent to the organization thereof, the exchange rate in effect on the date of acquisition of the investment should be substituted for the acquisition (of asset) date rate in the subsequent translation of real-value assets. If the foreign currency unit is materially altered, in terms of its dollar value, as the result of a sudden and substantial devaluation, it is appropriate to abandon all use of pre-devaluation exchange rates in order to deal exclusively in terms of the "new" foreign currency units.

It must be recognized that present conditions in the foreign exchange area make it somewhat inappropriate in many circumstances to speak of exchange rate in the singular form. This has been done in the present chapter in order to focus attention on the problems incident to the translation of asset, liability, and net worth items. A later chapter will examine the problems created by the existence of a "family" of exchange rates.

CHAPTER II

TRANSLATION OF ACCOUNTS EXPRESSED IN FOREIGN CURRENCIES INTO DOLLARS - REVENUE AND EXPENSE ACCOUNTS

In the preceding chapter, techniques for the translation of foreign currency asset, liability, and net worth accounts into dollars were developed. The present chapter will continue this investigation by examining the procedures which are appropriate for the translation of revenue and expense account balances.

It is apparent that the problem of determining the aggregate dollar profit or loss resulting from the operations of a foreign subsidiary for a particular accounting period has been solved when appropriate procedures for the determination of dollar net assets at the beginning and end of such period have been developed. Thus, if the results of applying the translation procedures developed in the preceding chapter showed dollar net assets of $50,000 at the beginning of a particular accounting period and of $60,000 at the end of the same period, with no dividends having been declared and no change in contributed capital having occurred during the period, there is no question but what the total profit for the period was $10,000. This conclusion is the inevitable result of the application of the familiar accounting equation, Assets = Liabilities + Net Worth, or if the reader prefers, Assets - Liabilities = Net Worth. If all that is desired in the way of information regarding the results of operations of the foreign subsidiary is the total profit or loss for a particular period there is no reason for continuing the inquiry further, the techniques set forth in the preceding chapter having provided the necessary technical equipment to

arrive at a satisfactory solution. In the typical situation, however, it is necessary, or at least desirable, to have more detailed information regarding the results of operations of a foreign subsidiary than a figure indicating total gain or loss. The determination of the dollar equivalent of specific revenue and expense items is obviously necessary if consolidation of the income statement of the foreign subsidiary with that of the domestic parent company is contemplated. Even if such consolidation is considered to be inappropriate in a particular case it is desirable for purposes of both internal and external reporting to produce a reasonably detailed statement of the results of foreign operations, which requires translation of individual revenue and expense accounts into dollars. Hence, it is apparent that the calculation of aggregate profit and loss by means of measuring change in dollar net assets is not satisfactory in terms of adequately reporting foreign operations.

Another factor related to the reporting of the results of foreign operations which causes the careful translation of specific revenue and expense accounts to assume substantial significance, is the desirability of distinguishing between profits or losses related to the ordinary manufacturing or merchandising activities and the gain or loss resulting from the movement of exchange rates. While this distinction may appear relatively meaningless to many, it seems essential to recognize the definite difference between these two types of gains or losses, a distinction which is particularly important in terms of the placement of responsibility for operating results. In a great many respects the distinction is the same as that which exists in the case of a strictly domestic operation as between gains or losses resulting from trading operations and gains or losses of a more or less windfall type resulting from movements in the domestic price level. Certainly the area of responsibility among management for

these two distinct types of gains or losses, as well as the controllability thereof by the management of the individual firm, differs sharply. It follows then that satisfactory reporting of foreign operations should separate at least in an approximate manner, these two components of the over-all net income or loss resulting from the operation of a foreign subsidiary. It appears that traditional translation procedure has almost completely ignored the real nature of the exchange adjustment (gain or loss) and has merely considered it as a necessary but relatively meaningless "plug" to achieve a balancing dollar trial balance of the accounts of the foreign subsidiary. In the discussion which follows in this and the succeeding chapter a rather rigorous point of view has deliberately been taken as to the necessity of precise determination of the exchange gain or loss. This seems appropriate in order to emphasize in a discussion of this type the real nature of the exchange adjustment emerging from various techniques of translating revenue and expense accounts. It is equally appropriate to emphasize that such meticulous calculation of the exchange adjustment is not essential in an actual situation involving translation of foreign balances, so long as the nature of the adjustment is reasonably well recognized and responsibility therefore assigned accordingly.

The remainder of the present chapter will deal with an examination of presently employed procedures for translating foreign currency revenue and expense accounts and of the fundamental criteria and resulting techniques which should be employed in this process.

Presently Employed Procedures for Translating Revenue and Expense Items

The discussion which follows relating to currently employed revenue and expense translation procedures will be divided into two sections. In the first the most commonly employed procedures will be briefly described. Following this description, short examples of the application of each of

the various methods will be presented in order to point out the assumptions underlying its use and the effect thereof in terms of the resulting dollar net earnings. More extensive illustrations of the translation of revenue and expense account balances will be presented in Chapter III.

Although it is difficult to generalize as to current practice in the area of translating foreign currency revenue and expense items, the examination of a substantial number of published reports of United States corporations having foreign subsidiaries has indicated that a relatively few methods have achieved rather wide acceptance. It is important to mention in this connection that the information contained in published reports relating to translation procedure is frequently rather vague and the conclusions which have been drawn from such information are subject to this limitation.

The method of translating revenue and expense accounts which is suggested in most textbook treatments of the subject is that of applying to all such accounts, with the exception of depreciation or amortization, some sort of an average of the exchange rates in effect during the period for which revenue and expense accounts are being translated. Depreciation and amortization charges are almost universally translated by the application of the exchange rate in effect when the depreciable asset was acquired. It is obvious that the term "average" is subject to a variety of meanings. Among the companies which are more specific in this connection the indication that "average" refers to an average of month-end rates seems to be most common. No mention was made in any of the reports examined as to whether the month-end rates were weighted in any manner to give effect to varying significance of particular months in terms of the volume of operating transactions taking place during such month (as would occur in a seasonal situation). The omission of such information implies that the

average rate employed in most cases is an unweighted average of month-end rates.

Another type of average which is occasionally employed in this connection is the average of the exchange rates in effect on the dates at which funds were transmitted by the foreign subsidiary to the United States. A convenient method of calculating such an average is to divide the total number of foreign currency units remitted to the United States by the total number of dollars produced by such remittances. It is apparent that in a situation involving a fairly large number of remittances during a particular period, especially if such remittances were made at regular intervals, the results of this calculation would very likely closely approximate the results of calculating an average of month-end rates. Where an average remittance rate is employed, it is still typical to translate depreciation or amortization at the rate in effect when the depreciable assets were acquired.

A third procedure which is fairly widely employed is to translate revenues and expenses by months at the exchange rate in effect at the end of each month, with depreciation being translated by use of the historical (acquisition) rate.

A fourth technique of translating foreign currency revenue and expense account balances is to apply to all such accounts (except depreciation) the exchange rate in effect on the closing date of the accounting period for which such accounts are being translated.

A fifth method, which is employed by one of the most prominent United States corporations,[1] actually represents a combination of the second and fourth methods mentioned above. This technique involves translating net income to the extent of current dividend remittances at the

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[1]Standard Oil Company (New Jersey).

dollar equivalent of such remittances, with unremitted net income being translated at year-end rates, except that depreciation charges are based on original dollar cost.

Having briefly described the most commonly employed techniques of translating operating account balances, it is now appropriate to briefly examine the most significant methods in terms of the assumptions underlying them and to illustrate the application of each to a concrete set of figures.

For the purpose of examining the alternative techniques of translating foreign currency revenues and expenses, the following illustrative example will be employed.

The X Company was organized on January 1, 1953, on which date its condensed opening trial balance, expressed in foreign currency units, appeared as follows:

X COMPANY
Trial Balance
January 1, 1953

	Foreign Currency Units	
Miscellaneous current assets	90,000	
Inventory	10,000	
Fixed assets	150,000	
Current liabilities		50,000
Capital stock		200,000
	250,000	250,000

It is assumed that all of the accounts included in the miscellaneous current asset category on the above trial balance are of the type previously described as money-value assets. The fixed assets have an estimated life for depreciation purposes of ten years. The exchange rate in effect on January 1, 1953, was three foreign currency units to one dollar. Thus, the January 1, 1953 trial balance expressed in dollars would appear as follows:

X COMPANY
Trial Balance
January 1, 1953

	Dollars	
Miscellaneous current assets	30,000	
Inventory	3,333	
Fixed assets	50,000	
Current liabilities		16,667
Capital stock		66,666
	83,333	83,333

The dollar amounts in the preceding trial balance result from applying the three foreign currency units to one dollar exchange rate to the foreign currency balances. On January 1, 1953, this is both the current rate (for the purpose of translating miscellaneous current assets and current liabilities) and the acquisition rate (for the purpose of translating inventories, fixed assets, and capital stock).

Let us assume that the operations of the X Company for the year ended December 31, 1953, are set forth in the following income statement:

X COMPANY
Income Statement
Year ended December 31, 1953

	Foreign Currency Units		
Sales			200,000
Cost of goods sold:			
Beginning inventory	10,000		
Purchases	125,000		
Total	135,000		
Ending inventory	15,000	120,000	
Expenses:			
Depreciation		15,000	
Other		25,000	160,000
Net income			40,000

The December 31, 1953 trial balance of the X Company, giving effect to the results of operations for 1953, appears as follows:

X COMPANY
Trial Balance
December 31, 1953

	Foreign Currency Units	
Miscellaneous current assets	150,000	
Inventory	15,000	
Fixed assets	150,000	
Allowance for depreciation		15,000
Current liabilities		60,000
Capital stock		200,000
Retained earnings		40,000
	315,000	315,000

It will be noted that no additional investment in fixed assets occurred during 1953, and that no dividends were declared or paid.

For the purpose of this illustration it will be assumed that the following rates of exchange were in effect during 1953:

Period	Exchange Rate (Foreign Currency Units to One Dollar)
January 1 to April 30	3 to 1
May 1 to August 31	3 1/2 to 1
September 1 to December 31	4 to 1

Having presented a hypothetical situation, we are now prepared to explore the effects of various methods of translating revenues and expenses expressed in foreign currency. Our primary objective is to observe the alternative results in terms of the dollar net income which is produced by the application of the various methods. However, in order to evaluate the results produced by the various methods it is necessary to integrate the translation of revenue and expense and balance sheet accounts.

Average Rate of Exchange

Since available evidence indicates that the use of some sort of average rate of exchange for the purpose of translating foreign currency revenues and expenses is commonly employed in practice and certainly represents the typical textbook technique, its results will be examined first.

The application of the unweighted average rate of exchange in effect during 1953, e.g., 3 1/2 to 1, to the revenue and expense accounts (except for depreciation, which is translated at the acquisition rate) of the X Company for this period will produce the following dollar income statement:

X COMPANY
Income Statement
Year ended December 31, 1953

Sales		$57,143
Cost of goods sold	$34,286	
Expenses:		
Depreciation	5,000	
Other	7,143	46,429
Net income		$10,714

The preceding income statement does not give effect to any exchange gain or loss which resulted from changes in the dollar value of the foreign currency during 1953. In order to determine the magnitude of any such gain or loss it is necessary to translate the net assets of the X Company on December 31, 1953, and compare the amount thereof with the dollar net assets on January 1, 1953. The difference between these two magnitudes represents the over-all profit or loss for the year 1953, including profit or loss from normal foreign operations as well as the profit or loss (measured in dollars) resulting from changes in the rate of exchange. The December 31, 1953 trial balance of the X Company (expressed in dollars) would appear as follows:

X COMPANY
Trial Balance
December 31, 1953

	Dollars	
Miscellaneous current assets	37,500	
Inventory	3,750	
Fixed assets	50,000	
Allowance for depreciation		5,000
Current liabilities		15,000
Capital stock		66,666
Retained earnings - net income for the year per income statement		10,714
Exchange loss - to balance	6,130	
	97,380	97,380

The dollar amounts presented in the preceding trial balance are the result of applying what were described in the preceding chapter as conventional translation procedures, e.g., net current assets at the closing exchange rate (4 to 1) and fixed assets and contributed capital at the acquisition date exchange rate (3 to 1).

The computation of the dollar trial balance on December 31, 1953, permits the following calculation of aggregate net income to be made:

Dollar net assets - December 31, 1953	$71,250
Dollar net assets - January 1, 1953	66,666
Increase in dollar net assets - net income	$ 4,584

If the aggregate net income for the year ended December 31, 1953, was $4,584, the amount of the loss which resulted from the reduced dollar value of foreign currency units during 1953, may be computed as follows:

Net income - per translated income statement	$10,714
Aggregate net income - growth in dollar net assets	4,584
Loss resulting from decrease in dollar value of foreign currency	$ 6,130

Although it will be the purpose of the succeeding chapter to explore in detail the nature and significance of the exchange gain or loss, it is appropriate at this point, as a part of the evaluation of the various methods of translating revenue and expense accounts expressed in foreign currency, to briefly investigate the factors underlying the emergence of the exchange loss, as calculated in the preceding example. The following tabulation sets forth the reasons for the existence of an exchange loss of $6,130.

Revaluation in dollars of the beginning net current assets:			
50,000 foreign currency units @ 3 to 1		$16,666	
50,000 foreign currency units @ 4 to 1		12,500	
Decreased dollar value of beginning net current assets			$4,166
Revaluation in dollars of net current assets produced by 1953 profits from average to ending exchange rate:			
Net income	40,000		
Add depreciation	15,000		
Net current assets produced by profits	55,000		
55,000 foreign currency units @ 3 1/2 to 1		$15,714	
55,000 foreign currency units @ 4 to 1		13,750	
Decreased dollar value of net current assets produced by profits			1,964
Total exchange loss - reduction in dollar value of net current assets			$6,130

The preceding tabulation brings into rather clear focus the fundamental assumption underlying or justifying the use of the average rate of exchange in effect during a period for the purpose of translating foreign currency revenues and expenses. This assumption may be stated in one of two ways. The more popularly expressed justification, to the extent that accountants have given any attention to the reason for employing an average rate, is that the use of an average rate assumes that revenue and expense transactions are spread relatively regularly over the accounting period and application of an average exchange rate is a short cut method of translating each revenue and expense transaction at the rate in effect when it occurred. An alternative point of view involves the application of the assumption that all revenue and expense transactions occur on a particular hypothetical date on which the average rate of exchange was in effect. Thus, in the preceding example the results which emerged from the use of the average rate are those which would result if all sales and out-of-pocket expense transactions occurred during the second four months of

the year when the exchange rate in effect was 3 1/2 foreign currency units to 1 dollar. Resulting from this point of view is the necessity for including in the calculation of the exchange loss the revaluation of the net current assets produced by operations from the average rate of exchange in effect when the profits are assumed to have been earned to the closing rate of exchange. The evaluation of the use of an average rate as well as the other possibilities in translating foreign currency revenues and expenses will be deferred until a later point in this chapter following the examination of other methods and the discussion of the appropriate criteria relative to the translation of foreign earnings.

Average Remittance Rate

No detailed example of the application of the average remittance rate will be presented, since this technique merely represents a particular concept of how the average rate of exchange should be computed. Instead of averaging the exchange rates which were in effect during a particular operating period, this method takes the point of view that a more significant average results from dealing only with exchange rates which were in effect on the dates at which funds were transmitted from the foreign subsidiary to the domestic parent company. It is apparent, as was previously mentioned, that in a case where funds are remitted with reasonable regularity both in time and amount the average produced by this calculation would not differ materially from an average of exchange rates in effect during a period. This method gives effect to the assumption that revenue and expense transactions occur in the same time pattern as does the remittance of funds to the domestic parent company. The exchange adjustment which would result from the application of this method would give effect to the same revaluations of net current assets, expressed in dollars, as was the case in the preceding illustration, the only difference being the amount

of the revaluation of the net current assets produced by current period operations resulting from a different average rate being employed.

Month-End Exchange Rates

A detailed example of the use of month-end exchange rates will not be presented at this point since Chapter III includes an extended illustration in which this procedure is employed.

Closing Rate of Exchange

The translation of all revenue and expense accounts, except depreciation or amortization of fixed assets, at the exchange rate in effect on the closing date of the accounting period for which the translation is being made is a reasonably common method. The translation of the 1953 income statement of the X Company, using the exchange rate in effect on December 31, 1953, e.g., 4 to 1, would produce the following results:

X COMPANY
Income Statement
Year ended December 31, 1953

Sales		$50,000
Cost of goods sold	$30,000	
Expenses:		
Depreciation	5,000	
Other	6,250	41,250
Net income		$ 8,750

As was pointed out on the first page of the present chapter, the choice of the exchange rate to be employed in the translation of foreign currency revenues and expenses can have no effect on the aggregate dollar profit or loss resulting from the operations of a foreign subsidiary. The aggregate or over-all profit or loss is measured by the change in dollar net assets during the accounting period in question, taking into account distributions made to owners during such period. Hence, the aggregate net income of the X Company must be $4,584 for the year ended December 31, 1953. The only effect of the choice of exchange rate to be employed in

the translation of individual revenues and expenses is on the division of this total between net income or loss from ordinary operations and profit or loss resulting from exchange movements. Once again it is possible to calculate the exchange loss by comparing the aggregate profit or loss with the results of the translated income statement, as set forth in the following tabulation:

Net income - per translated income statement	$8,750
Aggregate net income - growth in dollar net assets	4,584
Loss resulting from decrease in dollar value of foreign currency	$4,166

In this case the exchange loss is merely the result of revaluing the January 1, 1953 net current assets (expressed in dollars) from a rate of 3 to 1 in effect on January 1, 1953, to a rate of 4 to 1 which was in effect on December 31, 1953, or $4,166 as shown in the calculation of the exchange loss in the section of this chapter dealing with the use of an average rate of exchange. The reason for this result is apparent when the assumption underlying the use of the closing rate is noted. In effect, the use of the closing rate of exchange is based upon the assumption that all revenue and expense transactions occur on the closing date of the accounting period for which the translation is being made. Thus, the net current assets produced by the profits of the current accounting period are assumed to have been received by the foreign subsidiary on the closing date and are not subject to any change in dollar value as a result of exchange rate movements. This is presumably motivated by a desire to emphasize the postulate of realization in the calculation of dollar earnings. The best measure of the number of dollars which may be expected to be realized as a result of the earnings of a foreign subsidiary is presumably obtained by translating the foreign currency earnings into dollars at the exchange rate which is current at the close of the accounting period.

There would seem to be little justification for such extensive emphasis on the postulate of realization, particularly in relation to the dollar valuation of foreign subsidiary earnings. In the typical case, if such exists, there is little likelihood that any substantial proportion of the net current assets produced by earnings will be transmitted to the domestic parent company. The need for reinvestment of such assets in the foreign subsidiary, as well as foreign government regulations restricting the international transmission of funds operate to limit rather severely the remittance of foreign earnings to the United States. Under these circumstances there is little realism in clinging to a dollar realization concept in the valuation of foreign earnings. This point of view quite obviously operates to cast serious doubt on the validity of the use of the closing rate in relation to the translation of foreign currency revenue and expense items.

Extra Dollar Depreciation

If the foreign currency net income of 40,000 currency units is translated as a single amount at the December 31, 1953 exchange rate of 4 to 1, the resulting dollar net income will quite apparently be $10,000. It will be noted that this amount is $1,250 larger than the dollar net income which resulted from the use of the closing rate in the preceding section. The reason for this difference relates to the difference produced by translating depreciation as a separate amount at the acquisition date exchange rate of 3 to 1 in the preceding illustration as compared with the inclusion of depreciation in the foreign currency net income when this amount is translated as a single amount by application of the closing date exchange rate. This difference may be precisely calculated as shown in the following tabulation:

Depreciation translated at acquisition date rate	$5,000
Depreciation charge included in the calculation of net income and translated as a part of net income at the closing date rate:	
15,000 foreign currency units @ 4 to 1	3,750
Difference	$1,250

This difference is commonly referred to as "extra dollar depreciation". Quite apparently if exchange rates move in the opposite direction from that which has been assumed in the illustrations in this chapter the difference calculated above will be in the opposite direction. It is difficult to see how this difference creates any serious problem in a practical situation since it would seem appropriate to deal with foreign earnings (expressed in dollars) as calculated by translating individual revenue and expense items. The translation of total earnings would seem to be appropriate only as a sort of approximate or memorandum computation. Again it must be recalled that the aggregate earnings of a foreign subsidiary may be computed quite independently of any attempt to translate individual income statement items, merely by dealing with the change in dollar net assets over a particular period of time, giving recognition to the dollar proceeds of any dividend distributions made during such period.

It should be emphasized that the preceding examples represent the author's interpretation of the methods of translating foreign currency revenue and expense items which available evidence indicates are currently employed. The illustrations have intentionally been kept quite simple in order to focus attention on the fundamental significance of the results produced by each method. The effect of the existence of dividends, foreign taxes based on income, additional purchases of fixed assets, the existence of long-term debt, as well as more frequent changes in the dollar value of the foreign currency will be examined in more complex illustrations in

the succeeding chapter. Expression of any opinion as to the relative appropriateness of the methods illustrated above will be deferred until the basic criteria which should govern the translation of foreign currency revenues and expenses have been discussed in the next section of this chapter. Modifications, which in the opinion of the author, should be made in the results of the illustrations already presented will also be considered at that point.

Criteria Governing the Translation of Revenue and Expense Items

In the following discussion of criteria which should govern the translation of foreign currency revenues and expenses, a deliberate effort will be made to deal with the problem on a substantially theoretical level. As will be emphasized, this sort of approach to the problem should not be interpreted as a plea for the application of such theoretically rigorous methods in an actual situation requiring translation of foreign balances. However, it is the feeling of the author that the acceptability of any of the methods which are practically applicable can be measured only by comparison of the results thereof with the results which emerge from the use of theoretically ideal techniques.

The most fundamental objective which should govern the translation of foreign currency revenues and expenses is to produce substantially the same dollar amounts for revenue and expense which would have been produced had the individual revenue or expense transactions been translated into dollars on the date on which the particular transaction occurred. Only if this is the case can it be said that the dollar results actually represent the dollar equivalent of the foreign currency revenues and expenses. It is immediately apparent that an attempt to translate each sale, purchase, or expense transaction using the exchange rate in effect on the date when the particular transaction occurred is impossible from a point of view of

practical expediency. Hence, it is necessary, as will be pointed out later in this chapter, to attempt to develop less burdensome mechanical techniques, the results of which will not differ materially from those produced by the application of the theoretically ideal procedure.

A second objective, which emerges automatically with application of the procedures suggested in the preceding paragraph, should be to produce as a result of the translation of balance sheet and income statement items an exchange rate gain or loss which is significant in terms of its amount in relation to its fundamental nature. It seems unquestionably true that translation procedures as they are suggested in textbooks and employed in practice have rather consistently ignored this objective with the result that the exchange gain or loss represents nothing more than a "plug" which is necessary to achieve a balancing dollar trial balance in a situation in which more than one rate of exchange is employed to translate various items in the trial balance. As was set forth in the preceding chapter, the exchange gain or loss should represent the change in the dollar value of foreign currency assets and liabilities, the value of which is expressed in terms of a fixed or contractually determined number of foreign currency units, e.g., cash, receivables, and all debts. If intelligent appraisal of the efficiency of the management of a foreign subsidiary is to be made it seems essential to separate accurately the gain or loss resulting from ordinary merchandising or manufacturing activities from the gain or loss resulting from the impact of changes in the dollar value of the foreign currency on the investment of the particular firm in so-called money-value assets and liabilities. Gains or losses resulting from movements in the dollar value of the foreign currency are definitely the result of a risk which is inherent in carrying on business activities which are expressed in a currency different from that employed by the parent company or home

office, and as such represent a part of the over-all profit or loss resulting from foreign operations. However, such gains or losses are distinctly different in terms of controllability and managerial responsibility from merchandising or manufacturing gains or losses and for this reason their magnitude should be determined in a reasonably refined manner. More extensive attention will be devoted to this matter in the succeeding chapter.

Recommended Revenue and Expense Translation Procedures

The following discussion of specific translation procedures will be divided into four sections dealing with revenues, out-of-pocket expenses,[2] depreciation or amortization, and dividends.

Revenues

Revenue items should, at the theoretical level, be translated by application of the exchange rate in effect on the date on which each increment of the annual total of revenue has been recognized. As mentioned above, it becomes immediately apparent that the rigid application of this rule would, in a situation involving any substantial number of revenue transactions, create an inordinately large number of mechanical translation operations. Hence, it is proposed that revenue recognized during each month be translated at the exchange rate in effect on the last business day of that month. This has the effect of assuming that the total revenue recorded during any month was earned on the last day of the month. In most situations the application of this technique will produce results which do not differ materially from those produced by the individual translation of each revenue transaction. Only when rapid and substantial changes

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[2]The term out-of-pocket expenses as it will be employed in this discussion includes expense items (including the cost of merchandise purchased), requiring current outlay of cash or incurrence of short-term payables.

in the dollar value of the foreign currency occur during a month will any particular distortion result from the use of month-end rates. As was mentioned in the preceding chapter, there is substantial doubt as to the validity of any attempt at translation in this sort of situation.

Out-of-Pocket Expenses

The exchange rate in effect on the date on which each item of expense of this type is recognized as being incurred represents the theoretically proper measure to employ in computing the dollar magnitude of foreign currency out-of-pocket expenses. Once again, however, it is necessary to compromise theoretical perfection with practical expediency, and again the most appropriate compromise would appear to be the use of month-end rates. Precisely the same considerations which were cited in the preceding paragraph would apply to the exact accuracy of the results of this procedure.

Depreciation and Amortization

Expenses representing the recognition of the consumption of costs incurred in prior accounting periods should be translated into dollars by applying the exchange rate in effect when the long-lived asset element in question was acquired. This procedure is consistent with the cost basis of computing depreciation and is also consistent with the method suggested for translating the cost of long-lived assets for balance sheet purposes.

Dividends

Although not a factor to be considered in connection with the computation of net income, the problem of translating the charge resulting from the declaration of a dividend is most appropriately discussed at this point. The same fundamental considerations would apply as in the case of out-of-pocket expense and the same procedure which was suggested at that

point is appropriate in this connection. However, in the case of dividend declarations, we are dealing with a type of transaction which occurs so infrequently that there is no problem, at the mechanical level, of employing the exchange rate in effect when the dividend was declared.

Evaluation of Currently Employed Methods of Translating Foreign Currency Revenues and Expenses

Having examined the fundamental criteria which should govern the translation of foreign currency revenues and expenses, it is now appropriate to compare the results of the methods which were examined and illustrated in the preceding section with those which would be produced by the application of the theoretically correct techniques outlined above.

As a preliminary to a discussion of the translation procedures previously illustrated in this chapter, it is desirable to tabulate the results of each of these methods in terms of the dollar net income from ordinary operations, the exchange loss, and the aggregate dollar net income.

	Average Exchange Rate	Closing Exchange Rate
Net income from operations	$10,714	$8,750
Exchange loss	6,130	4,166
Aggregate net income	$ 4,584	$4,584

It is appropriate to stress once more that, given the same data in terms of the transactions of the foreign subsidiary, the choice of method of translating the operating accounts of the foreign subsidiary can have no effect upon the magnitude of the aggregate dollar net income. Hence, if it is felt that nothing is gained by a careful distinction between operating net income and exchange gain or loss it is obvious that the translation procedure applied to revenue and expense accounts is immaterial. Under these circumstances it would seem appropriate to employ the translation procedure which involves the least effort, recognizing of course that the resulting dollar amounts for individual revenues and expenses and

for the exchange "plug" are relatively meaningless. Under these circumstances, the use of the closing rate or even a "standard" rate, approximating the rate in effect during the accounting period would seem to be most appropriate. There is little room for argument, however, that this point of view is not particularly defensible in terms of providing the necessary information for an adequate appraisal of the efficiency of the management of a foreign operation. Hence, it is desirable to inquire further into the acceptability of the techniques which have achieved reasonably wide acceptance.

On balance, it would seem to be reasonably clear that the use of an average rate of exchange most closely approximates the procedures suggested above as being most appropriate for the purpose of translating foreign currency revenues and expenses. In a situation involving reasonable stability of exchange rates and a fairly even distribution of revenue and expense transactions over the accounting period, the results of the use of an average rate should approximate rather closely the results produced by using daily or month-end rates. Of course, the method of computing the average rate to be employed for this purpose is of considerable significance in terms of the validity of the results which its use will produce. An average of the beginning and ending rates is considerably less satisfactory than an average of month-end rates. In other words, the more exchange rate quotations which are included in the computation of the average, the more satisfactory will be the results. If frequent remittances are made to the domestic parent company, there would seem to be no reason to believe that an average remittance rate would not be acceptable. In situations in which there is substantial seasonality associated with the operations of the foreign subsidiary coupled with movements of some size in the rate of exchange, the use of some sort of weighted average

would be preferable to the use of an unweighted average. This might take the form of applying weights giving some recognition to the relative magnitude of foreign revenues or expenses for each month to the month-end exchange rates.

The use of the closing rate of exchange has little to recommend its use in terms of the desired objectives of the translation of foreign currency revenues and expenses. There seems to be little justification in attempting to measure the dollar value of foreign earnings in terms of the dollar value of the foreign currency at the close of the period for which dollar financial statements are being prepared. Due to the need for reinvestment of earnings in the operations of the foreign subsidiary as well as the existence of restrictions upon the transmission of funds to the United States, the current dollar value of foreign earnings which have accrued over a period of time is not of great significance. Rather, the more appropriate objective, as previously stated should be to express the results of foreign operations as though the revenue and expense transactions had been originally consummated in terms of dollars. The use of the closing exchange rate for the purpose of translating foreign revenues and out-of-pocket expenses will produce results which are considerably at variance with this objective. Reference to the comparative tabulation presented at the beginning of this section is of interest in this connection. It will be noted that the use of the closing exchange rate, as compared to the use of an average rate, has the effect of revaluing downward the revenues and expenses (other than depreciation) related to ordinary operations to give recognition to the lower exchange rate in effect at the close of the operating period, while in fact these revenues and expenses were earned and incurred to a considerable degree in a substantially different environment in terms of the dollar value of the foreign currency.

As a compensating offset to the erroneous valuation of revenues and expenses, the exchange loss is substantially understated in comparison with the loss which in fact resulted from the declining dollar value of foreign currency money-value assets and liabilities. Perusal of the results of employing the closing exchange rate would not present a satisfactory basis for measuring the efficiency of the operating management of the X Company as contrasted with the area of financial management relating to the administration of foreign currency funds. The net-money-value assets which were generated by profitable operations did, in fact, become available during the course of the operating period and were in part available for investment in alternative ways or in some cases for transmission to the domestic parent company. It seems important that a fairly accurate indication of the loss in dollar value of such assets as a result of the particular investment policy which was followed be available as a part of the appraisal of the efficiency of financial administration. The use of the closing exchange rate does not do an acceptable job of even approximating the magnitude of such exchange losses, and hence does not represent a satisfactory translation technique.

The reader will no doubt have noted that the illustrations presented earlier in this chapter dealt with net current assets in connection with the computation of the exchange loss, while in both the preceding and present chapters the point was made that the exchange loss should measure the change in dollar value of net-money-value assets, as defined in the preceding chapter. This procedure was followed in the earlier illustrations in order to reflect as faithfully as possible what it is felt represents current practice. In concluding the discussion of alternative methods of translating foreign currency revenues and expenses, it is appropriate to point out certain modifications in the procedures suggested in the earlier

illustrations in relation to the distinction between money-value and non-money-value assets.

In order to avoid undue repetition, only the illustration involving the use of an average rate of exchange will be modified at this point. The only change in the illustration as it was previously presented relates to the calculation of dollar cost of goods sold. It will be recalled that the cost of goods sold, expressed in foreign currency units, was computed as follows:

Beginning inventory	10,000
Purchases	125,000
Total	135,000
Ending inventory	15,000
Cost of goods sold	120,000

On the income statement expressed in dollars the cost of goods sold of 120,000 foreign currency units was translated as a single figure by applying the average exchange rate of 3 1/2 to 1. It is possible that this is not an entirely fair depiction of current textbook procedure or practice, and it certainly does not represent a perfectly satisfactory technique in view of the nature of this particular expense element. As was pointed out in the preceding chapter, inventories represent a form of asset investment which is similar to fixed assets in regard to the expression of the value thereof in terms of a fixed number of foreign currency units. The expense element related to the disposition or consumption of inventories should properly be measured (in dollars) by the equivalent original dollar cost of the inventory items sold or consumed. It is apparent that this was not done in the dollar valuation of cost of goods sold in the original illustration of the use of an average exchange rate, in which case the foreign currency value of the total cost of goods sold was translated into dollars by use of the average exchange rate in effect during the accounting period, regardless of the rate in

effect when particular units (identified or assumed) were acquired. Let us assume that the closing inventory is composed of units which were acquired during the last four months of the year, when the exchange rate was 4 to 1. This assumption was made by implication in the original illustration, since the closing inventory was translated at a rate of 4 to 1 for balance sheet purposes. The calculation of cost of goods sold expressed in dollars as it should be computed giving effect to the non-money-value nature of inventories is presented below:

	Foreign Currency Units	Exchange Rate	Dollars
Beginning inventory	10,000	3 to 1	$ 3,333
Purchases	125,000	3 1/2 to 1	35,714
Total	135,000		$39,047
Ending inventory	15,000	4 to 1	3,750
Cost of goods sold	120,000		$35,297

The 1953 income statement, giving recognition to the revised computation of cost of goods sold would appear as follows:

X COMPANY
Income Statement
Year ended December 31, 1953

Sales		$57,143
Cost of goods sold	$35,297	
Expenses:		
Depreciation	5,000	
Other	7,143	47,440
Net income		$ 9,703

The exchange loss which emerges from the computation of net income as set forth above may be calculated as follows:

Net assets - December 31, 1953	$71,250
Capital stock - December 31, 1953	66,666
Retained earnings - December 31, 1953	$ 4,584
Net income for the year ended December 31, 1953 - as above	9,703
Exchange loss	$ 5,119

The cause of the exchange loss may be precisely determined, as shown in the following tabulation:

Revaluation in dollars of the beginning net-money-value assets:			
40,000 foreign currency units @ 3 to 1		$13,333	
40,000 foreign currency units @ 4 to 1		10,000	
Decreased dollar value of beginning net-money-value assets			$3,333
Revaluation in dollars of money-value assets produced by 1953 operations and retained in money-value form:			
Net income - foreign currency	40,000		
Add:			
Depreciation	15,000		
Beginning inventory	10,000		
Total	65,000		
Deduct amount invested in ending inventory	15,000		
Net-money-value assets produced by 1953 operations	50,000		
50,000 foreign currency units @ 3 1/2 to 1		$14,286	
50,000 foreign currency units @ 4 to 1		12,500	1,786
Exchange loss			$5,119

It is important to note the difference between the above tabulation and the comparable calculation on page 61 of this chapter. In the computation presented above the real nature of inventory as a non-money-value asset has been recognized and any loss attaching to it as a result of a decrease in the dollar value of the foreign currency has been eliminated. Precisely the same effect in regard to the treatment of the ending inventory is produced as though all or a part of the assets generated through operations had been invested in long-lived assets.

A comparison of the results of the present illustration with those shown by the original illustration of the use of an average rate of exchange discloses the following differences:

	Original Illustration	Present Illustration	Difference
Net income from operations	$10,714	$9,703	$1,011
Exchange loss	6,130	5,119	1,011
Aggregate net income	$ 4,584	$4,584	-0-

It will be noted that the difference between the two illustrations is simply a shift between net income from operations and exchange loss in the amount of $1,011, with no difference in the aggregate or over-all net income. The reason for this shift may be demonstrated by the following analysis of the difference between the two illustrations in terms of the difference in the magnitude of cost of goods sold, all other income statement items being the same. It will be recalled that in the original illustration of the use of an average exchange rate, the total foreign currency cost of goods sold was converted into dollars by applying thereto the average rate of exchange prevailing during 1953. The most convenient method of demonstrating the differing results of the two illustrations is to point out the effects of making this total translation instead of the individual translation of beginning inventory, purchases, and ending inventory. These effects may be summarized as follows:

The beginning inventory is included in cost of goods sold at an amount (in dollars) below its original dollar cost:		
10,000 foreign currency units @ 3 to 1 (original cost)	$3,333	
10,000 foreign currency units @ 3 1/2 to 1 (amount which is included in the translated value of total cost of goods sold)	2,857	
Understatement of cost of goods sold		$ 476
The ending inventory is implicitly included in the computation of cost of goods sold in terms of an exchange rate of 3 1/2 to 1, while it was acquired when the exchange rate was 4 to 1:		
15,000 foreign currency units @ 3 1/2 to 1	$4,285	
15,000 foreign currency units @ 4 to 1	3,750	
Understatement of cost of goods sold		535
Total understatement of cost of goods sold and overstatement of net income from operations resulting from translating total foreign currency cost of goods sold at the average exchange rate		$1,011

There appears to be no reason to conclude that the results of the second illustration of the use of the average exchange rate, in which proper

recognition is given to the nature of inventory in terms of its non-money-value nature, does not produce the more accurate results in terms of both net income from operations and exchange loss. There are undoubtedly many accountants who feel that the aggregate net income resulting from the operations of a foreign subsidiary is the only significant figure and that any attempt to distinguish in a reasonably precise manner between profit or loss resulting from manufacturing and merchandising activities and profit or loss created by exchange rate movements is meaningless. The conclusions of the author in this connection have been set forth in previous sections of this chapter and will not be repeated at this point.

Recognition of the nature of inventory as it effects the translation process should also be introduced into the process of translating revenue and expense items if the closing rate or a combination of remittance and closing rates are used for this purpose. In the interests of avoiding undue repetition, the effect of such recognition on the latter methods will not be illustrated at this point.

Summary

The present chapter has been concerned with the translation of foreign currency revenues and expenses and the resulting determination of dollar net income from the operation of a foreign subsidiary. The approach to this problem which has been selected has been to discuss and illustrate the techniques most commonly employed for this purpose, to set forth the criteria which should govern the acceptability of a method, and to evaluate the methods which were illustrated against the backdrop of these criteria.

It is appropriate at this point to repeat the criteria which should be employed in the evaluation of any particular method. It will be recalled that these were two in number and included:

(1) The translation process should produce dollar amounts for foreign currency revenues and expenses as nearly as possible (within the limits of practicality) the same as would have emerged from the expression of the results of each revenue and expense transaction in terms of the dollar value thereof on the date when it occurred.

(2) The translation process should result in a reasonably precise separation of the results of ordinary operations from the result of changes in the dollar value of the foreign currency. Ideally, the latter element should be the result of the impact of exchange rate movements on the dollar value of net-money-value assets.

The results required by the criteria set forth above would be produced only by a translation of each revenue and expense transaction at the exchange rate prevailing when it occurred. In most, if not all, cases this procedure is so burdensome mechanically that it becomes practically impossible to apply. It was concluded that a reasonably accurate approximation of theoretical perfection may be achieved with a substantial reduction in the mechanical burden of the translation process through the use of an average of the exchange rates in effect during a particular accounting period. The more refined the calculation of this average, in terms of including monthly or even daily exchange rate quotations therein, the more satisfactory the results. Special problems may arise in foreign operations involving a considerable element of seasonality in the volume of revenue and expense transactions, and in these cases the use of some sort of weighted average has been recommended. It will be recalled that the choice of method of translation has no effect on the aggregate or over-all net income produced by the operations of a foreign subsidiary, this amount being the result of increase or decrease in dollar net assets during a particular period. The effect of the use of alternative methods is entirely in the area of the division of such aggregate net income between that resulting from ordinary operations and that resulting from exchange rate movements.

It is especially important that proper recognition of the distinction between money-value and non-money-value assets and liabilities, introduced in the preceding chapter, be made in the process of translating the results of foreign operations into dollars. This distinction, as has been pointed out, affects the translation of foreign revenues and expenses in connection with the depreciation or amortization of the cost of long-lived asset elements and in relation to the computation of cost of goods sold, because of the impact of the dollar valuation of inventories thereon. As was stated in the preceding chapter the term "inventories" includes expense prepayments as well as stocks of materials or merchandise.

The following chapter will continue the inquiry into the results of translating foreign currency revenues and expenses, with particular reference to the exchange gain or loss which results (in the absence of complete stability in the exchange rate) from the translation process.

CHAPTER III

EXCHANGE GAIN OR LOSS

In the preceding chapter several illustrations of the translation of foreign currency revenues and expenses were presented in order to point out the differing effects of alternative procedures. In connection with these illustrations, considerable attention was given to the magnitude and cause of the gain or loss resulting from changes in the dollar value of the foreign currency. It was maintained that a reasonably precise determination of the exchange gain or loss in line with its true nature should be one of the fundamental criteria to be applied in connection with the evaluation of the acceptability of a particular technique of translating foreign earnings. In the present chapter, further attention will be devoted to the general problem of the exchange gain or loss, including consideration of the value of any attempt to distinguish between realized and unrealized gains or losses of this type and the proper disposition in the accounts of such gain or loss. The present chapter will conclude with a detailed illustration of the translation process in order to illustrate in an integrated form the conclusions of Chapters I and II and to introduce some complicating features not examined in the illustrations presented in these chapters.

Nature of the Exchange Gain or Loss

At several points in the two preceding chapters it has been stated that the exchange gain or loss should reflect the change in dollar value of foreign currency assets and liabilities, the foreign currency value of which is precisely determinable. A change in dollar value of such assets

quite apparently will be the result of a change in the dollar value of the foreign currency unit resulting from movements in the exchange rate. This type of gain or loss is obviously distinctly different from the gain or loss resulting from manufacturing or trading activities of the foreign subsidiary and for this reason considerable emphasis has been placed on the desirability of a reasonably accurate measurement thereof. The definition of the exchange gain or loss set forth above differs in one important respect from the traditional concept of this element. To the extent that any consideration has been given to the real nature of the exchange gain or loss, the typical point of view is that it represents the change in dollar value of the working capital of the foreign subsidiary, using the term working capital in the sense of the excess of current assets over current liabilities. It will be noted that the definition offered above suggests the removal from the working capital quantum of asset elements, the value of which does not represent a fixed number of foreign currency units. Specifically, this would involve the elimination of inventories, including in this term expense prepayments. It is difficult to visualize how the dollar value of a stock of merchandise held by a foreign subsidiary varies directly and proportionately with movements in the prevailing rate of exchange, while such variation in the dollar value of so-called money-value assets and liabilities would appear to be in accordance with the inherent nature of such assets and liabilities.

It is interesting to note the close similarity between the phenomenon of changes in the dollar value of money-value foreign currency assets and liabilities accompanying exchange rate movements and the changing economic significance of comparable assets and liabilities in a strictly domestic situation accompanying a change in the internal price level. The following paragraph sets forth rather clearly the effect on money-value

assets of a change in the domestic price level:

> Suppose a corporation, for example, has a million dollars in cash at the beginning of a particular year and retains this amount intact in the bank throughout the year, and during that year the price level moves up 50 per cent, so that a dollar at the end of the year will buy only two-thirds of what it would at the beginning of the year. The accounts show an unchanged figure in cash and of course the figure is correct as far as the present balance is concerned, because cash is an item that automatically converts to current dollars: but the thing that is not brought out is that the company has actually lost $500,000 of purchasing power measured in terms of the year-end dollar and a third of a million dollars measured in terms of the more valuable beginning-of-the-year dollars.[1]

The loss in purchasing power which is described in the above paragraph is parallel in significance to the change in dollar value of a foreign cash balance resulting from a fifty per cent increase in the number of foreign currency units required to purchase one United States dollar in the foreign exchange market. In both cases the loss is commonly described as unrealized and there is no compulsion to give recognition thereto in the accounts of the domestic corporation involved. It is interesting to note, however, that accountants are quite agreeable to consider the loss as an appropriate charge against revenue or surplus in the case of the foreign currency translation, but resist rather strongly any attempt to recognize the analagous domestic loss, even in the form of supplementary financial statements.

Realized Versus Unrealized Exchange Gains and Losses

It has become typical in the literature dealing with the general area of the accounting problems relating to foreign operations, as well as in published corporate reports, to distinguish between realized and unrealized exchange gains or losses, and to suggest the possibility of differing accounting treatment as between the two. Thus, the American Institute of

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[1] W. A. Paton, "Measuring Profits Under Inflation Conditions," Journal of Accountancy, January, 1950, pp. 16-27.

Accountants has recommended:

> 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.[2]

In the 1948 annual report of Armour and Company the following item is included in the computation of foreign subsidiary earnings; "Unrealized exchange loss on translation of foreign accounts into U.S. currency."

The above quotations indicate that the terms "realized" and "unrealized" are apparently an accepted part of accounting terminology in relation to foreign exchange gains and losses. This would seem to justify the expectation that reasonably well established principles would have been developed which would govern the classification of exchange losses as realized or unrealized. This is definitely not the case, however. While the terms "realized" and "unrealized" are used quite glibly in this connection, little, if any attention has been given to setting down the meanings of the terms in any sort of concrete or specific manner. Perhaps those who have written in this area have felt that the distinction between realized and unrealized exchange gains or losses is so obvious as not to require further discussion. This hardly appears to be a defensible point of view. It is well recognized that no general agreement exists among accountants as to the proper connotation of the terms "realized" and "unrealized" in situations involving no element of foreign currency translation. Thus, one person may consider the receipt of cash as the proper evidence of the realization of revenue while another considers the creation of a valid short-term claim to cash as equally indicative of realization. Under these circumstances it would appear to be particularly appropriate that rather clear

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[2]American Institute of Accountants - Committee on Accounting Procedure, op. cit., p. 31.

cut criteria of realization of foreign exchange gains or losses be developed, which, as was previously mentioned, has not been done.

Although it is difficult, if not impossible, to discover a clear cut distinction between realized and unrealized exchange gains and losses in the literature, it seems reasonable to conclude that the generally employed criterion of realization in this connection is the transmission of funds to the domestic parent corporation. Before discussing the validity of this point of view it will be helpful to present an illustrative situation to demonstrate the operation of this concept of realization.

For the purpose of this illustration, it is convenient to employ the data used in the first illustration in Chapter II. Reference to page 58 will show the following foreign currency trial balance of the X Company on December 31, 1953:

X COMPANY
Trial Balance
December 31, 1953

Miscellaneous current assets	150,000	
Inventory	15,000	
Fixed assets	150,000	
Allowance for depreciation		15,000
Current liabilities		60,000
Capital stock		200,000
Retained earnings		40,000
	315,000	315,000

This same trial balance was expressed in dollars as follows:

X COMPANY
Trial Balance
December 31, 1953

Miscellaneous current assets	37,500	
Inventory	3,750	
Fixed assets	50,000	
Allowance for depreciation		5,000
Current liabilities		15,000
Capital stock		66,666
Retained earnings		4,584
	91,250	91,250

It will be recalled from the illustration in Chapter II that the retained earnings balance on December 31, 1953, assuming the use of an average rate of exchange in the translation of 1953 operations, included the following elements:

Net income from operations	$10,714
Exchange loss	6,130
Net income	$ 4,584

Under a remittance criterion of realization the exchange loss for the year 1953 would be considered as being unrealized in total, since no part of the earnings for this year were remitted, in the form of dividends, to the parent corporation.

In order to introduce the distinction between realized and unrealized gains or losses, assume that the exchange rate changed on January 1, 1954, from the four foreign currency units to one dollar rate which prevailed during the last quarter of 1953, to five foreign currency units to one dollar. This would cause an additional exchange loss of $4,500, as evidenced by the following trial balance, expressed in dollars (assuming that no transactions occurred on January 1, 1954, to alter the December 31, 1953 foreign currency account balances):

X COMPANY
Trial Balance
January 1, 1954

Miscellaneous current assets	30,000	
Inventory	3,750	
Fixed assets	50,000	
Allowance for depreciation		5,000
Current liabilities		12,000
Capital stock		66,666
Retained earnings, December 31, 1953		4,584
Exchange loss	4,500	
	88,250	88,250

The dollar balances in the preceding trial balance are unchanged from those appearing in the December 31, 1953 trial balance with the exception of the miscellaneous current asset and current liability classifications. The

dollar balances of these items have been developed by applying the new current exchange rate of five to one with a resulting decrease as compared with the December 31, 1953 balances. The cause of the exchange loss resulting from the change in exchange rate from four to one to five to one is shown in the following tabulation:

Foreign currency value of net-money-value assets subject to fluctuation in dollar value:	
Miscellaneous current assets	150,000
Current liabilities	60,000
Net	90,000
90,000 foreign currency units @ 4 to 1	$22,500
90,000 foreign currency units @ 5 to 1	18,000
Decrease in dollar value of net-money-value assets	$ 4,500

This additional $4,500 exchange loss would still, under what may be described as conventional procedure, be considered as unrealized, since no remittances have been made to the parent company. In order to introduce a realized loss, assume that a dividend of 20,000 foreign currency units was declared and remitted to the United States parent company on January 15, 1954, when the exchange rate was still five to one. Assume also that the accounting period of the parent company is the calendar year and that recognition by it of subsidiary earnings (if any recognition is given to undistributed foreign earnings) was made to December 31, 1953. The remittance of a dividend of 20,000 foreign currency units would, under the apparently prevailing concept of realization, involve the realization of a previously unrealized exchange loss of $1,000, calculated as follows:

Amount at which the assets remitted to the parent company were valued (in dollars) on December 31, 1953 - 20,000 @ 4 to 1	$5,000
Dollar proceeds of the 20,000 foreign currency unit dividends on January 15, 1954 - 20,000 foreign currency units @ 5 to 1	4,000
Exchange loss realized by dividend remittance	$1,000

The receipt of the dividend by the domestic parent company would presumably be recorded in one of the following ways, depending upon the method employed by the parent company of carrying the investment in the X Company:

	Investment Account Carried At Equity in Subsidiary Net Assets		Investment Account Carried At Cost	
Cash	4,000		4,000	
Exchange loss	1,000		1,000	
Investment in subsidiary		5,000		
Dividend income				5,000

If it is felt, as is the case in this discussion, that exchange gains and losses are an inherent feature of the operation of a foreign subsidiary and hence are properly a part of the over-all earnings of the foreign subsidiary, the exchange loss recognized in the preceding entries would be considered to be a part of the over-all net income or loss of the foreign subsidiary for the year ended December 31, 1954.

It is interesting to note the effect of the preceding entry, prepared in connection with the use of the equity in net assets basis of accounting for the investment in the foreign subsidiary, on the parent company's investment account. This account, since the date on which the foreign subsidiary was organized, would appear as follows:

Cost, January 1, 1953	$66,666
Net income for the year ended December 31, 1953	4,584
Total - Net assets December 31, 1953	$71,250
Deduct credit for dividend received	5,000
Balance, January 15, 1954	$66,250

That the $66,250 balance in the investment account on January 15, 1954 does not accurately depict the dollar net assets of the foreign subsidiary on that date, ignoring transactions between January 1, 1954 and January 15, 1954, may be shown by the following schedule setting forth the dollar net assets of the X Company on January 15, 1954:

Miscellaneous current assets	$26,000
Inventory	3,750
Fixed assets-net	45,000
Total	$74,750
Deduct current liabilities	12,000
Net assets	$62,750

The difference between the dollar net assets of the foreign subsidiary and the balance of the investment account on the records of the parent company ($66,250 - $62,750 = $3,500) is the total exchange loss of $4,500 created by the change in exchange rate on January 1, 1954, less the amount recognized as realized through the January 15, 1954 dividend remittance. To the extent that this so-called unrealized loss is not recorded by the parent company the investment account is overstated in terms of the underlying dollar net assets.

The logical conclusion regarding the validity or legitimacy of attempting to distinguish between realized and unrealized exchange losses in general and of employing a remittance criterion in making such a distinction in particular now begins to emerge. It seems impossible to escape the conclusion that the remittance of funds from a foreign subsidiary to a domestic parent company is an action which is of little if any significance insofar as the nature or status of a change in the dollar value of foreign net-money-value assets is concerned. This gain or loss occurred when movements in the prevailing rate of exchange caused a change in the dollar value of foreign net-money-value assets, and the remittance of all or a part of such money-value assets does nothing to alter the amount of the gain or loss or the point in time at which it actually occurs. There seems to be little point, in the entries illustrated on the preceding page, of the incomplete recording of $1,000 of the actual $4,500 exchange loss which occurred incident to the change in exchange rates on January 1, 1954. More satisfactory procedure would be to defer recognition of any exchange gain or loss which results from exchange rate movements during 1954, until

the net income of the foreign subsidiary for 1954, inclusive of the total exchange gain or loss for that period, is recorded by the parent company.

If it is felt to be desirable to distinguish between realized and unrealized exchange rate gains and losses, a more satisfactory criterion of realization than that of remittance to the domestic parent company should be sought. Since such gains or losses are a result of the existence of net-money-value assets in the possession of the foreign subsidiary, it would seem reasonable to associate the realization of such gains or losses with the alteration in the form of asset holdings from money-value to non-money-value form, as well as withdrawal of such assets from the subsidiary by remittances to the parent company. This point of view would result in exchange gains or losses being considered as being realized upon the consummation of any of the following types of transactions involving the utilization or application of net-money-value assets:

(1) Acquisition of inventories.
(2) Acquisition of long-lived assets.
(3) Remittance of dividends to the parent company.

Thus, when cash is employed to purchase an item of machinery, any gain or loss resulting from previous alteration in the dollar value of the amount of cash expended for this purpose should be considered as having been realized, since the utilization of cash for this purpose eliminates the possibility of further exchange rate gain or loss occurring as a result of future exchange rate movements. It is apparent than an attempt to distinguish between realized and unrealized exchange gains or losses on this basis, while theoretically sound, would create the necessity for a substantial volume of mechanical calculations. In view of the conclusions of the preceding paragraph as to the inadvisability or even inaccuracy of attempting to separate realized and unrealized losses, it is readily apparent how the attempt to separate realized and unrealized gains or losses

can, and in fact should, be avoided.

Further evidence as to the inappropriateness of attempting to distinguish between realized and unrealized exchange gains or losses, and particularly to do so on the basis of remittances to the parent company, becomes apparent when we consider situations in which it is the intention, or the necessity in recognition of existing exchange restrictions, to transmit only a small part of the results of profitable operations of a foreign subsidiary to the parent company. Quite apparently, if it is the intention of the parent company to expand the scale of operations of the foreign subsidiary, such expansion will require retention of a substantial portion of the working capital generated by profitable operations. The only alternative would be additional investment by the parent company, which, coupled with concurrent dividend remittances by the subsidiary would not represent a particularly rational financial policy. In a particular case, formal recognition of the intention to reinvest working capital generated by profits in the foreign subsidiary may even be made in the form of a stock dividend. In situations of this type continued consideration of the altered dollar value of foreign assets as representing an unrealized gain or loss certainly does not appear to give recognition to the facts of the situation.

In summary, it seems appropriate to conclude that gains or losses resulting from the altered dollar value of foreign money-value assets should be considered as representing a proper component of the over-all operating results of the foreign subsidiary, and that such gains or losses should be given recognition in connection with the translation of foreign balances into dollars when they occur as evidenced by exchange rate movements, with no attempt being made to distinguish between realized and unrealized exchange gains or losses.

Disposition of Exchange Gain or Loss

Having discussed the nature of the exchange gain or loss, as well as the undesirability of separating realized and unrealized gains or losses, it is now appropriate to consider the proper treatment to be accorded such items at the recording and reporting level.

The first decision which must be reached in order to deal adequately with the present inquiry relates to the establishment of appropriate boundaries relative to the scope of foreign operations. Should the operations of a foreign subsidiary be considered to end with the internal operations of the subsidiary, thereby eliminating from the measurement of the results of foreign operations the effect of exchange rate fluctuations, or should this boundary be widened to include the effect of expressing the financial position and operating results of the foreign subsidiary in the currency units employed by the parent company? The answer to this question has been briefly set forth at a previous point in this chapter. At that point it was stated that the effect of exchange rate movements on the dollar value of foreign holdings was felt to represent an inherent feature of the carrying on of business activities which are initially expressed in a different currency from that employed by the parent company (or home office). This position has been given recognition in professional society recommendations in the following words: "A loss arising through a fall in foreign exchange is a risk incidental to foreign business....."[3] Acceptance of this position requires extending the boundaries of foreign operations so that they, in effect, extend to the shores of the country in which the parent company is domiciled, thereby embracing as a part of the measurement of the result of foreign operations any effect of change in the dollar value

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[3]American Institute of Accountants - Research Department, op. cit.

of the foreign currency. The impact of this concept of the scope of the term "foreign operations" at the accounting level is to require the inclusion in the income statement of the foreign subsidiary any gain or loss resulting from exchange rate movements, and by this token to exclude such items from the measurement of profit or loss of the parent company from its own operations. This is the procedure which it will be recalled was employed in the illustrations in this and the preceding chapter.

The next problem which arises in this connection is the decision as to the assignment of the gain or loss resulting from exchange rate movements as between current operating results as opposed to absorption in the residual equity (retained earnings). At this point in the discussion the exchange gain or loss which will be considered will be restricted to that resulting from what may be called normal or market exchange rate fluctuations, excluding from the discussion the gain or loss caused by abrupt and substantial alteration in the dollar value of the foreign currency resulting from devaluation. This subject will be considered in connection with the examination of the general impact of devaluation in Chapter IV.

As a preliminary to an examination of the specific problem of assignment of foreign exchange gain or loss, it is necessary to review the general problem of the accounting recognition of gains or losses as between inclusion in the current period income statement and direct charge or credit to retained earnings or other type of surplus. Probably the most influential pronouncement in this connection is that contained in Accounting Research Bulletin Number 32 - Income and Earned Surplus, which includes the following recommendation:

> .....it is the opinion of the committee that there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception to this presumption in any case would be with respect to items which in the aggregate are materially significant in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period.[4]

The Bulletin continues by enumerating five categories of items which may be considered to fall within the scope of the last sentence in the preceding paragraph. In general these categories embrace material items of a non-recurring type and material corrections of prior years' operations.

The preceding statement would seem to indicate that, in general, all gains or losses should be reflected in the current period income statement. However, the suggestion that certain types of gains or losses may be excluded from the determination of net income for the period quite obviously introduces a substantial element of subjectivity into the making of a decision regarding proper treatment of a particular item. This is not the place for an extended discussion of the "current operating performance" as opposed to the "all-inclusive" concepts of the income statement. Our interest at this point is merely in the recommendation that exclusion of any gain or loss from the current period income statement is the exception and should be supported by reasonable evidence that inclusion in the income statement would cause material distortion of the significance of the net income for the particular period.

Turning now to the specific problem of the appropriate disposition of the gain or loss resulting from exchange rate movements, the following statement is in point:

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[4]American Institute of Accountants - Committee on Accounting Procedure, Bulletin Number Thirty Two - Income and Earned Surplus, 1947, p. 263.

> A loss arising through a fall in foreign exchange is a risk incidental to foreign business, and should be a charge to operating accounts and not a charge to surplus; however, in such a year as the present, the item will be a substantial one in many cases, and may be stated separately in the published accounts of a business, if so desired. All businesses engaged in foreign trade have what may be considered normal exchange differences which would properly be included under the ordinary captions. It is probably impossible to formulate an absolute general rule to cover the determination of the amount of special loss on foreign exchange during such financial periods as are now closing.[5]

The substantial exchange loss which is referred to in the above paragraph refers to the effect on the dollar value of many foreign currencies during 1931, as a result of abandonment of the gold standard. It will be recalled that this problem will receive subsequent consideration. The effect of ordinary or market changes in exchange rates of the type in which we are interested at this point are covered in the first sentence of the preceding paragraph, at which point it is recommended that such items should be included in the computation of current period net income. It should be noted that the preceding paragraph refers only to losses, since exchange adjustments in this direction were the general rule at the time this statement was drafted. It is doubtful if the Committee would reach the same conclusion in regard to inclusion in the income statement of exchange gains, since such gains would likely be considered as unrealized and hence not appropriately includible in the calculation of current net income. This question will receive further consideration below.

The following statement represents a somewhat more recent recommendation in the same area:

> 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.

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[5]American Institute of Accountants - Special Committee on Accounting Procedure, Memorandum on Foreign Exchange, 1931.

> In considering whether such a provision should or should not be deducted in arriving at the amount of net income for the year from which the net income per share is ordinarily computed, it must not be overlooked that if the amount of the provision is relatively large, the balance shown before making the deduction, the deduction itself, and the balance after making the deduction are all significant. It is desirable that investors should consider the component elements of net income and surplus changes and should be given reasonable information to enable them to do so, and that they should not be encouraged to attach undue importance to a single figure.
>
> Where a corporation publishes a continuous statement of income and surplus, the situation can be met by showing the income before and after the deduction of the provision and refraining from describing either figure as 'Net Income for the Year' without amplification of the expression.
>
> Where the corporation's practice is to carry the balance of income to a separate surplus statement, either (1) the provision should appear as a charge in the income statement, the balance before and after the charge perhaps being shown, or (2) if the amount and the circumstances are such that this would seriously impair the value of the income statement as an indication of earning capacity, and the charge for that reason is made to surplus, a clear disclosure of the treatment should appear in a note in the income statement.[6]

It should be noted that the preceding statement was issued before Bulletin 32 dealing with the general matter of income versus surplus charges or credits, and hence its recommendations regarding statement presentation of the exchange gain or loss are subject to the subsequent general recommendation of this later pronouncement.

The validity of the distinction drawn in the statement quoted immediately above between realized and unrealized gains or losses has been commented upon extensively in the preceding section of this chapter. As has been previously pointed out, the statement gives no clue as to what should govern the classification of an exchange gain or loss as realized or unrealized. It would seem to be preferable to extend the recommendation of the first paragraph of the preceding statement relative to accounting recognition of realized gains and losses to cover all gains and losses

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[6]American Institute of Accountants - Committee on Accounting Procedure, op. cit., p. 31-2.

resulting from the altered dollar value of foreign money-value assets and liabilities. There certainly seems to be little, if any, validity to distinguishing between the income statement as opposed to surplus charge or credit treatment of exchange gains or losses on the basis of realization, especially since realization in this connection is such a hazy concept. Materiality of the amount of the exchange gain or loss in relation to operating net income of the foreign subsidiary represents the only possible logical basis for justifying a direct surplus charge or credit, and in view of the subjective aspect of materiality, it would seem preferable to consider the exchange gain or loss as properly representing a factor to be uniformly included in the computation of foreign net income, with adequate disclosure of the amount thereof, probably most desirably below the net operating income line. It should be recalled that we are here interested in the effect of market variations in exchange rates, as opposed to those caused by government decree, which by and large should not produce exchange gains or losses of such magnitude that materiality in relation to net income will be a problem.

The following statement sets forth the position of a prominent advanced accounting textbook on the problem of the appropriate disposition of exchange gains or losses. It is reproduced here not only to give recognition to textbook recommendations but also because it introduces a rather common procedure in this connection which follows from the attempt to separate realized and unrealized exchange gains and losses:

> First, the exchange adjustment may be made through Branch Profit and Loss. If the Branch Current account balance must be increased to make it agree with the branch net assets, the offsetting credit may be made to Branch Profit and Loss before the balance of that account is transferred to Earned Surplus. If the current account balance must be decreased, the offsetting debit may be made to Branch Profit and Loss.

> Second, the exchange adjustment may be made through a reserve for exchange, on the theory that the exchange fluctuation is an unrealized and an uncertain matter, and that any gains which seem to have been made by a favorable fluctuation during one year may be offset by losses from unfavorable fluctuations in a succeeding year. Therefore, it is more conservative to credit the exchange adjustment to a reserve, where it will be available to absorb exchange losses in the future. If no reserve exists, an exchange loss should be charged to Branch Profit and Loss; and if the loss exceeds the reserve, the excess should be charged to Branch Profit and Loss.[7]

It will be noted that the above statement refers to the disposition of exchange gain or loss resulting from the operation of a foreign branch, rather than a subsidiary corporation. This has no effect, however, upon the applicability of the recommendations which are made as to the disposition of exchange gain or loss. The first paragraph quoted above reflects precisely the recommendation set forth on the preceding page, namely that exchange gains or losses should be considered as a part of the computation of foreign earnings, expressed in dollars, in the period in which such gains or losses occurred. The second paragraph is the more important, however, in relation to the present inquiry. It suggests the advisability of making two types of subdivision of exchange gains or losses and disposing of such gains or losses on the basis of this classification. In the first place the necessity of recognizing a distinction between realized and unrealized exchange gains or losses is pointed out and in the second place a different treatment of exchange gains as opposed to exchange losses is advocated. It is only fair to point out that the suggestion regarding different treatment of exchange gains as opposed to exchange losses is a direct result of distinguishing between realized and unrealized gains or losses. It is well accepted conservative practice to recognize, as a part of current period

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[7]Finney and Miller, op. cit., p. 600.

net income, all unrealized losses but to exclude from the computation of net income all unrealized gains. Hence, if a distinction is drawn between realized and unrealized gains or losses it follows that different treatment should be accorded unrealized gains as compared with unrealized losses. In the preceding quotation this different treatment has taken the form of suggesting that unrealized exchange gains should not be reflected in net income, but should be credited to a "reserve". To introduce an element of consistency into the discussion it is then suggested that "unrealized" exchange losses be charged against the reserve created by past exchange gains, if such a reserve exists and is adequate to absorb such losses.

This type of procedure has achieved fairly wide adoption among corporations, the annual reports of which are available for examination. An example of the use of this technique is illustrated by the following statement:

> It is the policy of the Company to state all foreign currency assets and liabilities in U.S. dollars on the basis of exchange rates prevailing at the close of the year. Cumulative net gains resulting from the application of these rates are carried in reserves and losses are charged to the reserves from previously accumulated net gains or, if no such reserves are available to consolidated income.[8]

It is interesting to examine the implications of this policy as evidenced by its use by the United States Rubber Company. For example, in 1949, the exchange loss, largely occasioned by the devaluation of the Canadian dollar, exceeded available reserves and resulted in a substantial charge to income. In 1950, the value of the Canadian dollar increased causing an exchange gain to emerge. Since the amount of the gain was less than the loss which had been charged to income in the preceding year, it was credited to income, in spite of the policy set forth in the previous quotation. The effect of the use of reserves for the purpose of dealing

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[8]United States Rubber Company, Annual Report (1952).

with exchange gains and losses is also interesting, and once again United States Rubber Company presents an illuminating example. Prior to 1950, exchange gains were added to a General Reserve which was presented between liabilities and net worth on the consolidated balance sheet. Exchange losses were presumably charged against this same reserve. In the financial statements included in the 1950 annual report, the portion of the General Reserve which related to foreign activities was segregated and described as Foreign Activities Reserve, which was presented in a Reserve category on the consolidated balance sheet. Scrutiny of this reserve discloses that it has emerged from the following three different sources:

(1) Excess of past exchange gains over exchange losses.

(2) The portion of foreign earnings which are restricted as to remittance to the United States because of governmental exchange restrictions.

(3) Provision for possible future loss on foreign assets, offset by a charge included in the consolidated income statement.

It is readily apparent that the aggregate reserve is a conglomeration of unlike elements related to each other only in that all of the components are the result of the existence of foreign holdings. Number one actually represents a form of deferred revenue or gain, not recognized in current income because it is felt to be unrealized. Number two would be more properly presented as a contra to consolidated assets, representing the portion of the total thereof which is not felt to represent full-fledged dollar asset value. Number three represents an appropriation of net worth as an indication of possible future losses relating to foreign operations. This grouping of fundamentally unlike elements with the total thereof being accorded unsatisfactory balance sheet classification is a fairly common characteristic of extensive use of so-called reserves. The inconsistent treatment described above of exchange gains and losses as between income statement and reserve recognition is also a symptom of the

inherent possibility of employing reserves to stabilize reported net earnings artificially as between accounting periods. The unsatisfactory results in terms of both income determination and unrealistic balance sheet presentation cast serious doubts on the validity of the use of reserves in this as well as in many other connections.

It must be observed that when it is agreed that an attempt to distinguish between realized and unrealized exchange gains or losses is meaningless, the necessity for according differing treatment to exchange gains from that given exchange losses disappears. Then the change in dollar value of foreign currency money-value assets and liabilities occurring during any particular accounting period represents a full-fledged gain or loss to be given recognition in that period. The presumption would be that such gain or loss should be considered in the computation of the net income of the foreign subsidiary for the period during which the gain or loss occurred, but, in circumstances where the gain or loss is undeniably material in relation to foreign operating net income, a strong case may be made for a direct retained earnings charge or credit. If it is desired to create an appropriation of retained earnings as recognition of the possibility of future exchange losses, this should be accomplished by means of a charge to the retained earnings account, without affecting current period net income. Such a reserve should be returned directly to retained earnings and not employed to absorb the charge for exchange losses when and if such losses do occur.

A special problem relating to the disposition of exchange gains or losses exists when, on the records of the parent corporation or in the process of preparing consolidated financial statements for the domestic parent and foreign subsidiary, unremitted foreign earnings are excluded from parent company or consolidated net income. This is commonly done in situations in which there exist restrictions on the remittance of funds from the country

in which the foreign subsidiary is domiciled to the domestic parent corporation. Since this problem is closely related to that of consolidating the financial statements of a foreign subsidiary with those of the domestic parent company, it will be considered in detail in Chapter V.

Illustrative Example of Translation Procedure

As a conclusion to the discussion of the translation of the accounts of a foreign subsidiary contained in Chapters I, II, and III, a reasonably complex illustration of the translation process will now be presented. This illustration contains substantially more detailed information than the brief examples presented in Chapter II and continued in the present chapter. After presenting the facts of the situation, the resulting balances will be translated by the application of what may be called theoretically correct procedure. This will be followed by translation of the same foreign currency balances by the use of more typically employed techniques. It will then be possible to compare the results of the three translation operations in order to evaluate the acceptability of the various methods.

The transactions of the foreign subsidiary during the year 1953, are described below. For convenience the currency unit employed by the foreign subsidiary will be termed the "zeno".

January 1, 1953 - The entire issue of 10,000 shares of common stock was issued to the parent company for cash at 10 zenos per share.

January 1, 1953 - The foreign subsidiary made the following purchases of fixed assets for cash:

Item	Cost
Land	10,000 zenos
Building (40 year life)	50,000 zenos
Equipment (10 year life)	10,000 zenos

January 1, 1953 to December 31, 1953 - The operating transactions of the subsidiary are summarized in the following tabulations:

Month	Cash Transactions: Received from Customers	Cash Transactions: Paid to Merchandise Creditors	Cash Transactions: Paid for Expenses
January	2,000	4,000	3,000
February	24,000	18,000	2,000
March	18,000	20,000	3,000
April	33,000	24,000	3,000
May	30,000	30,000	4,000
June	28,000	32,000	4,000
July	28,000	28,000	5,000
August	35,000	30,000	5,000
September	30,000	32,000	4,000
October	26,000	28,000	5,000
November	20,000	20,000	6,000
December	30,000	32,000	6,000
Totals	304,000	298,000	50,000

Month	Sales	Purchases	Cost of Merchandise Sold
January	18,000	15,000	14,000
February	20,000	18,000	15,000
March	25,000	26,000	18,000
April	30,000	28,000	23,000
May	28,000	30,000	20,000
June	30,000	26,000	22,000
July	40,000	32,000	29,000
August	26,000	30,000	10,000
September	32,000	30,000	22,000
October	13,000	24,000	13,000
November	34,000	30,000	25,000
December	40,000	44,000	29,000
Totals	341,000	333,000	240,000

June 30, 1953 - 100,000 zenos were borrowed on a five-year note payable. Interest at a rate of 6% is payable annually on June 30.

September 30, 1953 - Additional equipment with an estimated service life of ten years was acquired at a cash cost of 40,000 zenos.

November 30, 1953 - A dividend of 18,000 zenos was declared and immediately remitted to the parent corporation.

Income taxes were payable to the foreign government at a rate of 50% of net income.

The exchange rates during each month of 1953 (expressed in terms of zenos to one dollar) were as follows:

January 1	20
January 2 - 31	22
February	22
March	20
April	22
May	26
June	24
July	26
August	30
September	25
October	28
November	30
December	30

It is assumed that the new rate becomes effective on the first day of each month, before any transactions for that month have occurred.

The effects of the preceding transactions are summarized on the following page, in order to determine the December 31, 1953 zeno trial balance. The following key may be used to identify each transaction:

Number	Transaction
1	Issuance of capital stock.
2	Purchase of land, building, and equipment.
3	Sales on account.
4	Purchases of merchandise on account.
5	Cash receipts.
6	Cash payments.
7	Cost of merchandise sold.
8	Proceeds of loan payable.
9	Purchase of additional equipment.
10	Remittance of dividend.
11	Depreciation of building.
12	Depreciation of equipment.
13	Accrued interest on loan payable.
14	Income tax.

Account	1953 Transactions Debit		1953 Transactions Credit		Trial Balance December 31, 1953 Debit	Trial Balance December 31, 1953 Credit
Cash	(1)	100,000	(2)	70,000		
	(5)	304,000	(6)	348,000	28,000	
	(8)	100,000	(9)	40,000		
			(10)	18,000		
Accounts receivable	(3)	341,000	(5)	304,000	37,000	
Merchandise inventory	(4)	333,000	(7)	240,000	93,000	
Land	(2)	10,000			10,000	
Building	(2)	50,000			50,000	
Allowance for depreciation - Building			(11)	1,250		1,250
Equipment	(2)	10,000				
	(9)	40,000			50,000	
Allowance for depreciation - Equipment			(12)	2,000		2,000
Accounts payable	(6)	298,000	(4)	333,000		35,000
Interest payable			(13)	3,000		3,000
Loan payable			(8)	100,000		100,000
Capital stock			(1)	100,000		100,000
Sales			(3)	341,000		341,000
Cost of goods sold	(7)	240,000			240,000	
Expenses	(6)	50,000			50,000	
Depreciation:						
Building	(11)	1,250			1,250	
Equipment	(12)	2,000			2,000	
Interest on loan payable	(13)	3,000			3,000	
Income tax	(14)	22,375			22,375	
Dividend paid	(10)	18,000			18,000	
Income tax payable			(14)	22,375		22,375
		1,922,625		1,922,625	604,625	604,625

The translation of the preceding trial balance from zenos to dollars is shown on the following page together with the supporting schedules related thereto. The basis of translation is set forth in the column between the zeno and dollar trial balances.

Account	Zeno Trial Balance December 31, 1953 Debit	Zeno Trial Balance December 31, 1953 Credit	Basis of Translation		Dollar Trial Balance December 31, 1953 Debit	Dollar Trial Balance December 31, 1953 Credit	DOLLARS Income Statement Debit	DOLLARS Income Statement Credit	DOLLARS Retained Earnings Debit	DOLLARS Retained Earnings Credit	DOLLARS Balance Sheet Debit	DOLLARS Balance Sheet Credit
Cash	28,000		30		933						933	
Accounts receivable	37,000		30		1,233						1,233	
Merchandise inventory	93,000		See schedule		3,146						3,146	
Land	10,000		20		500						500	
Building	50,000		20		2,500						2,500	
Allowance for depreciation- Building		1,250	20			63						63
Equipment	50,000		10,000 @ 20	500								
			40,000 @ 25	1,600	2,100						2,100	
Allowance for depreciation- Equipment		2,000	1,000 @ 20	50								
			1,000 @ 25	40		90						90
Accounts payable		35,000	30			1,167						1,167
Income tax payable		22,375	30			746						746
Interest payable		3,000	30			100						100
Loan payable		100,000	30			3,333						3,333
Capital stock		100,000	20			5,000						5,000
Sales		341,000	See schedule			13,462		13,462				
Cost of goods sold	240,000		do. do.		9,844		9,844					
Expenses	50,000		do. do.		1,932		1,932					
Depreciation:												
Building	1,250		See allowance for depreciation		63		63					
Equipment	2,000		See allowance for depreciation		90		90					
Interest on loan payable	3,000		See schedule		108		108					
Income tax	22,375		do. do.		905		905					
Dividend paid	19,000		30		600				600			
	604,625	604,625			23,954	23,961						
Exchange loss					7		7					
					23,961	23,961	12,949	13,462				
Net income							513			513		
							13,462	13,462	600	513		
Retained earnings, December 31, 1953 (Deficit)										87	87	
									600	600	10,499	10,499

The computation of the dollar cost of goods sold and of the December 31, 1953 merchandise inventory is set forth below. A first-in, first-out assumption as to the flow of merchandise cost has been employed.

Dollar Cost of Merchandise Purchased

Month of Purchase	Zeno Cost	Exchange Rate	Dollar Cost
January	15,000	22	$ 682
February	18,000	22	818
March	26,000	20	1,300
April	28,000	22	1,273
May	30,000	26	1,154
June	26,000	24	1,008
July	32,000	26	1,231
August	30,000	30	1,000
September	30,000	25	1,200
October	24,000	28	857
November	30,000	30	1,000
December	44,000	30	1,467
Totals	333,000		$12,990

Dollar Cost of December 31, 1953 Merchandise Inventory and Cost of Goods Sold

Month of Purchase (F. I. F. O. Basis)	Zeno Cost	Exchange Rate	Dollar Cost
December	44,000	30	$ 1,467
November	30,000	30	1,000
October	19,000	28	679
	93,000		$ 3,146

Dollar purchases	$12,990
Deduct dollar inventory - December 31, 1953	3,146
Dollar cost of goods sold	$ 9,844

The computation of dollar sales is presented in the following tabulation:

Month of Sale	Zeno Sales Price	Exchange Rate	Dollar Sales Price
January	18,000	22	$ 818
February	20,000	22	909
March	25,000	20	1,250
April	30,000	22	1,364
May	28,000	26	1,077
June	30,000	24	1,250
July	40,000	26	1,538
August	26,000	30	867
September	32,000	25	1,280
October	18,000	28	643
November	34,000	30	1,133
December	40,000	30	1,333
Totals	341,000		$13,462

The dollar out-of-pocket expenses for the year ended December 31, 1953, are computed as shown in the schedule presented below:

Month of Payment	Zeno Expense	Exchange Rate	Dollar Expense
January	3,000	22	$ 136
February	2,000	22	91
March	3,000	20	150
April	3,000	22	136
May	4,000	26	154
June	4,000	24	167
July	5,000	26	192
August	5,000	30	167
September	4,000	25	160
October	5,000	28	179
November	6,000	30	200
December	6,000	30	200
Totals	50,000		$1,932

The dollar interest expense is the result of the following translation:

Month Accrued	Zeno Interest	Exchange Rate	Dollar Interest
July	500	26	$ 19
August	500	30	17
September	500	25	20
October	500	28	18
November	500	30	17
December	500	30	17
Totals	3,000		$108

The dollar income tax charge was computed as follows:

Month	Zeno Net Income Before Income Tax	Zeno Income Tax @ 50%	Exchange Rate	Dollar Income Tax
January	813	407	22	$ 18
February	2,813	1,407	22	64
March	4,813	2,407	20	120
April	4,813	2,407	22	109
May	4,813	2,406	26	93
June	4,813	2,406	24	100
July	6,313	3,156	26	121
August	2,313	1,156	30	39
September	6,312	3,156	25	126
October	(1,021)	(510)	28	(18)
November	2,978	1,489	30	50
December	4,977	2,488	30	83
Totals	44,750	22,375		$905

The remainder of the accounts included on the December 31, 1953 trial balance have been translated in accordance with the procedures developed in Chapters I and II. These included translation of money-value assets and liabilities (including the long-term loan in this category) at the December 31, 1953 rate, long-lived assets together with related depreciation expense and accumulated allowances, at acquisition date rates, capital stock at the issuance date rate, and the dividend charge at the rate in effect on the date of remittance.

It will be noted that the translation of the December 31, 1953 zeno trial balance into dollars necessitated the insertion of an exchange loss of $7 in order to achieve a balancing dollar trial balance. Since it is the object of this section of this illustration to deal with the problem of translating foreign currency balances in a theoretically precise manner it is appropriate to develop the reason for the existence of this exchange loss. As was pointed out earlier in this chapter, an exchange gain or loss is the result of the impact on the dollar value of foreign money-value assets and liabilities of movements in the rate of exchange during a particular accounting

period. Hence, the development of the cause of the exchange adjustment in this illustration requires the computation of the change in the dollar value of the specific money-value assets and liabilities existing during 1953. More specifically, in this example, the cause of the exchange loss of $7 will be found in the altered dollar value during 1953 of the following asset and liability items:

Cash
Accounts receivable
Accounts payable
Income tax payable
Interest payable
Loan payable

There are numerous mechanical possibilities as to the procedure of computing the altered dollar value of the above items. The method employed below is felt to be the most convenient, particularly in the case of active items such as cash, accounts receivable, and accounts payable.[9] Since the dollar value of the foreign currency tended to decrease during 1953, as evidenced by the increasing number of foreign currency units necessary to equal one dollar, the expected result would be to find that an exchange loss was suffered on money-value assets, offset almost entirely in this illustration by exchange gains on money-value liabilities.

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[9]This method is employed by W. A. Paton, Advanced Accounting (New York: The Macmillan Company, 1949) to calculate the loss in value of fixed dollar items caused by an increase in the domestic price level.

Loss on Decreased Dollar Value of Foreign Cash

Receipts

Month	Zenos	Exchange Rate	Equivalent Dollars
January 1	100,000	20	$ 5,000
January	2,000	22	91
February	24,000	22	1,091
March	18,000	20	900
April	33,000	22	1,500
May	30,000	26	1,154
June	128,000	24	5,333
July	28,000	26	1,077
August	35,000	30	1,167
September	30,000	25	1,200
October	26,000	28	929
November	20,000	30	667
December	30,000	30	1,000
	504,000		$21,109

Disbursements

Month	Zenos	Exchange Rate	Equivalent Dollars
January 1	70,000	20	$ 3,500
January	7,000	22	318
February	20,000	22	909
March	23,000	20	1,150
April	27,000	22	1,227
May	34,000	26	1,308
June	36,000	24	1,500
July	33,000	26	1,269
August	35,000	30	1,167
September	76,000	25	3,040
October	33,000	28	1,179
November	44,000	30	1,467
December	38,000	30	1,267
December 31, balance	28,000	30	933
Exchange loss			875
	504,000		$21,109

The preceding tabulation indicates that a loss of $875 was incurred as a result of the reduced dollar value of foreign cash during 1953. This loss is measured by the excess of the equivalent dollar value of cash received over the equivalent dollar value of cash disbursements and ending cash balance. An alternative method of arriving at the same result is to measure the reduction in dollar value of foreign cash at the end of each

month when the rate of exchange changes, as shown in the following schedule:

Date	Zeno Cash Balance	Translated at Old Rate	Translated at New Rate	(Gain) Loss
January 1	30,000	₱1,500	₱1,364	₱136
January 31	25,000	1,136	1,136	-0-
February 28	29,000	1,318	1,450	(132)
March 31	24,000	1,200	1,091	109
April 30	30,000	1,364	1,154	210
May 31	26,000	1,000	1,083	(83)
June 30	118,000	4,917	4,538	379
July 31	113,000	4,346	3,767	579
August 31	113,000	3,767	4,520	(753)
September 30	67,000	2,680	2,393	287
October 31	60,000	2,143	2,000	143
November 30	24,000	800	800	-0-
December 31	16,000	533	533	-0-
Net loss				₱875

In the case of Accounts Receivable and Accounts Payable the exchange gain or loss will be calculated by use of the first method only.

Loss on Decreased Dollar Value of Foreign Accounts Receivable

Sales

Month	Zenos	Exchange Rate	Equivalent Dollars
January	18,000	22	$ 818
February	20,000	22	909
March	25,000	20	1,250
April	30,000	22	1,364
May	28,000	26	1,077
June	30,000	24	1,250
July	40,000	26	1,538
August	26,000	30	867
September	32,000	25	1,280
October	18,000	28	643
November	34,000	30	1,133
December	40,000	30	1,333
	341,000		$13,462

Collections from Customers

Month	Zenos	Exchange Rate	Equivalent Dollars
January	2,000	22	$ 91
February	24,000	22	1,091
March	18,000	20	900
April	33,000	22	1,500
May	30,000	26	1,154
June	28,000	24	1,167
July	28,000	26	1,077
August	35,000	30	1,167
September	30,000	25	1,200
October	26,000	28	929
November	20,000	30	667
December	30,000	30	1,000
December 31, balance	37,000	30	1,233
Exchange loss			286
	341,000		$13,462

Gain on Decreased Value of Foreign Accounts Payable

Payments to Creditors

Month	Zenos	Exchange Rate	Equivalent Dollars
January	4,000	22	$ 182
February	18,000	22	818
March	20,000	20	1,000
April	24,000	22	1,091
May	30,000	26	1,154
June	32,000	24	1,333
July	28,000	26	1,077
August	30,000	30	1,000
September	32,000	25	1,280
October	28,000	28	1,000
November	20,000	30	667
December	32,000	30	1,067
December 31, balance	35,000	30	1,167
Exchange gain			154
	333,000		$12,990

Purchases

Month	Zenos	Exchange Rate	Equivalent Dollars
January	15,000	22	$ 682
February	18,000	22	818
March	26,000	20	1,300
April	28,000	22	1,273
May	30,000	26	1,154
June	26,000	24	1,008
July	32,000	26	1,231
August	30,000	30	1,000
September	30,000	25	1,200
October	24,000	28	857
November	30,000	30	1,000
December	44,000	30	1,467
	333,000		$12,990

The calculation of the exchange gain due to decreased dollar value of the remaining three liability items, Income tax payable, Interest payable, and Loan payable may be made by comparing the equivalent dollar value of the related charge with the dollar value of the liability on December 31, 1953, as shown in the following tabulation:

	Income Tax Payable	Interest Payable	Loan Payable
Equivalent dollar value of related charge:			
Income tax	$905		
Interest on loan payable		$108	
Cash proceeds of loan payable			$4,166
Dollar liability - December 31, 1953	746	100	3,333
Gain	$159	$ 8	$ 833

The gains and losses resulting from changes in the dollar value of foreign currency money-value assets and liabilities may be summarized as follows:

Loss on:		
Cash	$875	
Accounts receivable	286	
Total losses		$1,161
Gain on:		
Accounts payable	$154	
Income tax payable	159	
Interest payable	8	
Loan payable	833	
Total gains		1,154
Net loss		$ 7

The preceding tabulation emphasizes some rather interesting relationships. In general, it indicates how the existence of liabilities which are payable in foreign currency acts as a hedge against the effect of changes in the dollar value of money-value assets. In particular, the effect of the long-term loan payable in foreign currency should be noted. The decreased dollar value of this liability, together with the liability for interest thereon was responsible for offsetting $341 of the loss caused by decreased dollar value of foreign currency money-value assets. It would certainly seem appropriate that management be made aware of the type of information contained in the preceding tabulation, although of course the exact dollar magnitude of the various gains and losses would presumably not be essential.

The obvious conclusion to be drawn is that it is desirable to minimize the investment in net-money-value assets in order to minimize the risk of loss due to decreased dollar value thereof. If exchange rates move in the opposite direction from that assumed in this illustration, it is apparent that a net exchange gain would emerge. However, the typical objective underlying the formation and operation of a foreign subsidiary is to engage in manufacturing and selling activities, not to speculate on the course of foreign exchange rates.

In order to compare the results of the translation procedure employed above with two of the commonly employed methods, the zeno trial balance will be translated again with revenue and expense accounts translated by use of: (1) average rate of exchange, and (2) closing rate of exchange.

The use of the average rate of exchange will be illustrated first. The average rate which prevailed during 1953, and which will be used to translate sales, purchases, expenses, interest, and income taxes may be calculated by adding the thirteen exchange rate quotations given on page 105 and dividing the total by thirteen. This produces an unweighted average exchange rate of twenty five foreign currency units to one dollar.

Account	Zeno Trial Balance December 31, 1953 Debit	Zeno Trial Balance December 31, 1953 Credit	Basis of Translation		Dollar Trial Balance December 31, 1953 Debit	Dollar Trial Balance December 31, 1953 Credit	DOLLARS Income Statement Debit	Income Statement Credit	Retained Earnings Debit	Retained Earnings Credit	Balance Sheet Debit	Balance Sheet Credit
Cash	28,000		30		933							
Accounts receivable	37,000		30		1,233						933	
Merchandise inventory	93,000		See schedule		3,146						1,233	
Land	10,000		20		500						3,146	
Building	50,000		20		2,500						500	
Allowance for depreciation - Building		1,250	20			63					2,500	63
Equipment	50,000		10,000 @ 20	500								
			40,000 @ 25	1,600	2,100						2,100	
Allowance for depreciation - Equipment		2,000	1,000 @ 20	50								
			1,000 @ 25	40		90						90
Accounts payable		35,000	30			1,167						1,167
Income tax payable		22,375	30			746						746
Interest payable		3,000	30			100						100
Loan payable		100,000	30			3,333						3,333
Capital stock		100,000	20			5,000						5,000
Sales		341,000	25			13,640		13,640				
Cost of goods sold	240,000		See schedule		10,174		10,174					
Expenses	50,000		25		2,000		2,000					
Depreciation: Building	1,250		See allowance for depreciation		63		63					
Equipment	2,000		See allowance for depreciation		90		90					
Interest on loan payable	3,000		25		120		120					
Income tax	22,375		25		895		895					
Dividend paid	18,000		30		600				600			
	604,625	604,625			24,354	24,139						
Exchange gain						215		215				
					24,354	24,354	13,342	13,855				
Net income							513			513		
							13,855	13,855				
Retained earnings, December 31, 1953 (Deficit)										87	87	
									600	600	10,499	10,499

The computation of the dollar cost of goods sold is presented in the following schedule:

Computation of Dollar Cost of Goods Sold

Dollar cost of merchandise purchased:				
333,000 zenos ÷ 25				$13,320
Deduct dollar cost of December 31, 1953 inventory (computed on the F.I.F.O. basis)				
Month of Purchase	Zeno Cost	Exchange Rate	Dollar Cost	
December	44,000	30	$1,467	
November	30,000	30	1,000	
October	19,000	28	679	3,146
	93,000			
Dollar cost of goods sold				$10,174

As the final section of this illustration the use of the December 31, 1953 exchange rate for the purpose of translating nominal account balances will be demonstrated.

Account	Zeno Trial Balance December 31, 1953 Debit	Zeno Trial Balance December 31, 1953 Credit	Basis of Translation	Dollar Trial Balance December 31, 1953 Debit	Dollar Trial Balance December 31, 1953 Credit	DOLLARS Income Statement Debit	Income Statement Credit	Retained Earnings Debit	Retained Earnings Credit	Balance Sheet Debit	Balance Sheet Credit
Cash	28,000		30	933						933	
Accounts receivable	37,000		30	1,233						1,233	
Merchandise inventory	93,000		See schedule	3,146						3,146	
Land	10,000		20	500						500	
Building	50,000		20	2,500						2,500	
Allowance for depreciation - Building		1,250	20		63						63
Equipment	50,000		10,000 @ 20 500								
			40,000 @ 25 1,600	2,100						2,100	
Allowance for depreciation - Equipment		2,000	1,000 @ 20 50								
			1,000 @ 25 40		90						90
Accounts payable		35,000	30		1,167						1,167
Income tax payable		22,375	30		746						746
Interest payable		3,000	30		100						100
Loan payable		100,000	30		3,333						3,333
Capital stock		100,000	20		5,000						5,000
Sales		341,000	30		11,366		11,366				
Cost of goods sold	240,000		See schedule	7,954		7,954					
Expenses	50,000		30	1,666		1,666					
Depreciation:											
Building	1,250		See allowance for depreciation	63		63					
Equipment	2,000		See allowance for depreciation	90		90					
Interest on loan payable	3,000		30	100		100					
Income tax	22,375		30	746		746					
Dividend paid	13,000		30	600				600			
	604,625	604,625		21,631	21,865						
Exchange loss				234		234					
				21,865	21,865	10,853	11,366				
Net income						513			513		
						11,366	11,366				
Retained earnings, December 31, 1953 (Deficit)									87	87	
								600	600	10,499	10,499

The computation of the dollar cost of goods sold is shown in the following tabulation:

Computation of Dollar Cost of Goods Sold

Dollar cost of merchandise purchased:				
333,000 zenos ÷ 30				$11,100
Deduct dollar cost of December 31, 1953 inventory (computed on the F.I.F.O. basis)				
Month of Purchase	Zeno Cost	Exchange Rate	Dollar Cost	
December	44,000	30	$1,467	
November	30,000	30	1,000	
October	19,000	28	679	3,146
	93,000			
Dollar cost of goods sold				$ 7,954

It is now appropriate to examine the results of the three translation techniques illustrated above and to analyze the difference in results which emerge from their use.

In the first place, it will be noted that there is no difference in the balance sheet account balances produced by the three methods. This would be expected since in all three cases the balance sheet accounts were translated into dollars by use of the methods developed in Chapter I. The only possible objection to the employment of the same balance sheet translation procedures in conjunction with differing methods of translating nominal account balances would be in relation to the computation of dollar cost of goods sold and ending inventories. In this connection, it may appear inconsistent to translate the cost of merchandise purchased into dollars by use of the average or closing exchange rate and to calculate dollar cost of goods sold by subtracting from this amount the specific equivalent dollar cost of the most recent purchases. If it is recalled, however, that the first-in, first-out assumption as to the flow of inventory costs was selected for use in these illustrations, the compatibility of the procedures employed should be apparent. If it was desired to employ an average cost

method the translation of the zeno cost of the December 31, 1953 inventory into dollars would be made by employing the average exchange rate in effect during the year. Likewise, if last-in, first-out were to be employed, the closing inventory should be priced in dollars at the equivalent dollar cost of the appropriate amount of the earliest purchases. The use of the average exchange rate for the purpose of translating the zeno cost of merchandise purchased into dollars merely represents a short cut method of approximating the calculation of the precise equivalent dollar cost and has no particular impact on the selection of an assumption relative to the flow of merchandise costs.

Since there is no difference between the dollar balances of asset, liability, and net worth accounts on December 31, 1953, it is apparent that the over-all net income resulting from the application of the alternative techniques of translating revenue and expense accounts cannot differ. However, the individual revenue and expense items related to the determination of over-all net income show substantial differences in amount, as disclosed by the following tabulation:

	Method of Translating Revenue and Expense Items		
	Month-End Rates	Average Rate	Closing Rate
Sales	$13,462	$13,640	$11,366
Cost of goods sold	9,844	10,174	7,954
Gross profit	$ 3,618	$ 3,466	$ 3,412
Operating expenses:			
Miscellaneous	$ 1,932	$ 2,000	$ 1,666
Depreciation:			
Building	63	63	63
Equipment	90	90	90
Interest	108	120	100
Income taxes	905	895	746
Total operating expenses	$ 3,098	$ 3,168	$ 2,665
Net income from operations	$ 520	$ 298	$ 747
Exchange gain (loss)	(7)	215	(234)
Net income	$ 513	$ 513	$ 513

It is reasonable to conclude that the results of the use of month-end exchange rates represent the most accurate depiction of the dollar equivalent of foreign currency revenues and expenses as well as the most rational amount for the exchange gain or loss. Since this is the case, it is appropriate to explore the underlying reasons giving rise to the substantial (percentage wise) differences resulting from the use of the average and closing rates.

Turning first to an investigation of the results of employing an average rate to translate revenues and expenses, it will be noted that the use of the average exchange rate as compared with the use of month-end rates has caused a shift from net income from operations to the exchange gain of $222. While this amount is not large, it represents a substantial percentage of the correct net income from operations and the over-all net income. The reason for this shift in this example is largely due to the following factors. It will be recalled that the volume of operating transactions tended to increase from month to month during 1953, while the use of an average rate attached equal importance to the exchange rate in effect during each month. This alone would not cause an appreciable change in the dollar net income from operations if the individual monthly totals of sales, purchases, and expenses were each approximately the same proportion of the annual total. It will be noted, however, that this is not the case. The fact that merchandise is purchased prior to sale causes purchases for the earlier months to be more significant in relation to total purchases for the year than are the sales figures for the same months. Also the existence of fixed expenses causes the earlier months of the year to be more significant in this connection in relation to sales revenue than the later months. The result of this pattern of revenue and expense transactions coupled with the use of an average exchange rate causes more effect on purchases and

expenses, although in the same direction, than on sales, with a reduction in net income from operations and a shift to gain on exchange. If the incidence of sales, purchases, and expenses by months was reasonably constant, as contrasted to the situation in this illustration, the results of the use of an average rate of exchange would produce results more closely approximating those produced by the use of month-end rates.

The use of the closing rate of exchange for the purpose of translating revenue and out-of-pocket expense items produces results which differ substantially from those emerging from the application of either of the techniques discussed in the preceding paragraph. As would be expected, in view of the lower dollar value of the foreign currency on December 31, 1953, as compared with its value during the year, the amounts shown in the dollar income statement for all items of revenue and expense (except depreciation) are smaller when the closing rate is employed than under the other two translation procedures. However, the decrease in expense items, including cost of goods sold, is greater than the decrease in revenue, thus producing a substantially larger amount for net income from operations than either of the other methods. This results in a larger exchange loss than in the other cases, since the final net income figure must necessarily be identical in all three cases.

Since it would be expected that the use of the closing exchange rate would produce a smaller exchange loss than the other methods for a period during which the dollar value of the foreign currency declined, it is appropriate to inquire as to why this result did not emerge in this particular case. The principal reason that the use of the closing rate will normally produce a lower exchange loss during a period of depreciating foreign currency value is that the use thereof eliminates any recognition of the loss in dollar value of net-money-value assets produced by

operations. However, in this case, when the reinvestment in merchandise inventory of money-value assets produced by profitable operations is considered there was actually a negative impact of 1953 operations on the investment in money-value assets, as shown by the following schedule:

	Zenos
Net income	22,375
Add depreciation	3,250
Total money-value assets produced by operations	25,625
Deduct investment in December 31, 1953 merchandise inventory	93,000
Negative money-value assets produced by operations	67,375

It is interesting to observe that the revaluation of this amount (67,375) from the average rate (25) to the closing rate (30) is precisely the difference between the exchange gain - loss resulting from the use of an average exchange rate as compared with the use of the closing rate as shown below:

67,375 zenos @ 25	$2,695
67,375 zenos @ 30	2,246
Difference - gain	$ 449

It must be recalled that the 67,375 zenos in the above tabulation represents a negative magnitude and hence a decline in dollar value represents a gain.

It is obviously impossible to develop conclusions of general validity from a single hypothetical situation since the facts of the situation may be tailored to produce a desired result. There would seem to be no reason to conclude, however, that the illustration employed in this chapter does not represent a reasonably typical situation. On the basis of the results produced by the application of alternative techniques of translating operating accounts in this illustration it would seem reasonable to conclude that use of either the average or closing rate may produce results which differ substantially from the results emerging from the more theoretically correct use of month-end rates. In relatively stable situations, both in terms of

exchange rate movements and volatility of monthly revenues and expenses, the use of an average of exchange rates in effect during the year may be expected to approximate the results of monthly translation of revenues and expenses. The use of the closing exchange rate has little to recommend its use, since the results produced thereby will not even approximate the actual dollar equivalent of foreign currency revenues and expenses. Since the process of translating foreign balances is only a periodic one, typically annual in its incidence, it appears reasonable to recommend the use of month-end rates in connection with revenues and expenses in order to be reasonably certain that satisfactory reporting of the results of foreign operations exists.

It is interesting to note that the December 31, 1953 dollar balance sheet in the preceding illustration shows a negative retained earnings or earned surplus balance while the foreign currency balance sheet, had it been presented, would show positive retained earnings of 4,375 zenos. This represents a strikingly similar situation to that which may appear in strictly domestic situations when recognition is given to the impact at the reporting level of substantial increases in the internal price level. The foreign currency statements would be parallel to the conventional unadjusted dollar statements of a domestic corporation and the translated dollar statements would be analagous to the results of applying price level indices to the conventional domestic statements. In both cases what initially appears to represent a satisfactory situation relative to the relationship of earnings and dividends turns out to show that dividends have actually been paid from contributed capital. This is another indication of the rather close relationship which exists between the problems of expressing foreign currency statements in dollars and of giving recognition to the impact of the changing economic significance of the dollar in a strictly internal situation.

Summary

The present chapter has continued the inquiry into the problem of translating foreign currency revenue and expense items into dollars, with particular emphasis on the exchange gain or loss component of foreign earnings.

It was concluded that it is unrealistic, if not impossible, to distinguish between realized and unrealized exchange gains or losses. The exchange gain or loss is incurred and should be given recognition, normally in the foreign subsidiary income statement, in the period in which the movements of exchange rates alter the dollar value of foreign currency money-value assets and liabilities.

The chapter was concluded by presenting a more elaborate example of the translation of foreign balances than was shown in the preceding chapters. The transactions for a year were summarized by months so that translation by use of month-end rates could be performed and the resulting exchange loss analyzed in detail as to cause. For purpose of comparison, the same revenue and expense transactions were translated by use of the average and the closing exchange rates. The widely divergent results as between the three methods led to the conclusion that only through the use of month-end rates (or even more exacting procedures) can completely satisfactory dollar operating statements be achieved.

CHAPTER IV

THE IMPACT ON THE REPORTING OF FOREIGN OPERATIONS OF GOVERNMENT CONTROL OF THE FOREIGN EXCHANGE MARKET AND THE EXCHANGE RATES ESTABLISHED THEREIN

In the preceding chapters, procedures for the translation of foreign currency account balances into dollars have been developed in detail. The discussion has departed to a considerable degree from reality, however, as the result of a deliberate attempt to ignore at that point the impact of the wide variety of types of governmental control of the foreign exchange area. The existence of various degrees of control of exchange rates, as well as of the supply of and demand for foreign exchange, is the rule rather than the exception at the present time. For this reason it is essential to examine the general forms which such control may take and in particular the impact of exchange control on the reporting of foreign operations. For the purposes of this discussion the subject of governmental activity in the foreign exchange field will be divided into two sections. The first will deal with control mechanisms designed to establish and maintain a particular level of exchange rates, typically different from that which would result from the unhampered operations of free market forces. As is generally the case in relation to any type of price control, the successful maintenance of artificial "prices" for foreign currencies will necessarily result in rationing or allocating the available supply of the underpriced (in comparison with the price which would be established by the operation of free market forces) commodity, namely foreign exchange. A common phenomenon associated with government control of exchange rates is the existence of a variety of different rates for differing types of transactions with foreign

countries. The second division relates to the abrupt alteration by governmental action of the value of a currency in terms of the value of other currencies. This action most commonly involves a reduction in the value of the domestic currency and is typically described by the term "devaluation". It must be emphasized that this particular division of the discussion which follows does not reflect any fundamental difference or distinction between these two types of governmental intervention in the foreign exchange area. On the contrary, they are both part of the same broad area of international financial policy. In fact, devaluation of a currency is usually the result of the previous maintenance of an unrealistically high value (in terms of other currencies) for the devalued currency. This division was chosen merely because it represents a convenient classification for the purpose of examining the impact on the reporting of foreign operations of exchange control.

Forms and Purposes of Exchange Control

It should be emphasized at the outset that the discussion which follows does not pretend to be an exhaustive description of the wide variety of forms in which exchange control may manifest itself. Neither is it intended to represent a rigorously complete investigation of the objectives of such control. It is offered only in the thought that a brief examination of the most common forms of exchange control and the purposes motivating the adoption and retention of controls will be helpful in connection with the later exploration of the effect of the existence of such controls on the reporting of foreign operations.

Historical Development of Exchange Control - Pre-World War II

Although it is the major objective of this discussion to examine the effect on the reporting of foreign operations of exchange controls as they exist at the present time, it is desirable to survey very briefly the historical development of such controls. As is almost always the case in

connection with economic phenomena, it is difficult, if not impossible, to state with precision the birthdate of exchange controls. For the purposes of this discussion, however, it seems reasonable to consider that the international financial collapse of 1931, accompanied by widespread currency devaluations, was the signal for large scale governmental intervention into the international payments process. In this year and the year following many countries adopted some form of control of or influence on the free movement of exchange rates and of the international movement of funds.

Exchange Stabilization Funds

In general, these schemes of control took one of two basic forms. The first, illustrated by the British Exchange Equalization Account, established in 1932 and by the American Exchange-Stabilization Fund resulting from the devaluation of the dollar in 1934, took the form of a fund of assets under control of a government agency which is employed to buy and sell foreign exchange with the objective of minimizing fluctuations in exchange rates. In many ways the activities of such a fund are comparable to the effect of the activity of the United States Federal Reserve Board in pegging the prices of United States government bonds by means of open market purchases and sales. It was not the avowed purpose of stabilization funds to resist long-term movements in exchange rates caused by natural market forces, indeed the abandonment of the gold standard was substantially motivated by the necessity of freeing the foreign exchange market from the unnatural restrictions created by the tie to gold. Rather, the purchasing and selling activities of such a fund were to be aimed at the suppression of large short-term rate movements, often motivated by speculative factors. International cooperation among stabilization funds of individual countries was fostered by the Tripartite Agreement between Great Britain, France, and the United States in 1936.

Direct Exchange Controls

The second type of governmental activity in the international payments area may be illustrated by the German procedure. In many respects this example is more important to this discussion since many of the techniques which it included characterize the present situation regarding exchange control or restrictions. As a result of an import surplus during the 1920's, coupled with the necessity of making heavy reparation payments, the foreign exchange reserves of Germany were in a precarious position by 1930. During the 1920's substantial foreign credits had been extended to Germany on both long- and short-term account. By 1930, foreign lenders were beginning to lose confidence in the country's international finances and to withdraw short-term credits which accentuated the pressure on German foreign exchange reserves. In order to prevent a flight of capital to what was felt to be a safer location and to attempt to protect the external value of the currency from depreciation resulting from large scale capital movements, the German government assumed complete control of the foreign exchange market and prohibited all international transfers of capital in July, 1931. Although there was no immediate rationing of foreign exchange, the German authorities exercised substantial vigilance in the scrutiny of transactions involving foreign nationals in order to be sure that all foreign exchange which should become available from foreign transactions did in fact come into the possession of the control authorities. In addition, the making of barter arrangements to conserve foreign exchange while permitting trade to continue was a common practice. The use of clearing and payments agreements with various foreign powers developed to a substantial degree, usually at the initiative of the foreign government, with the objective of squeezing some amount of payment of old claims from the precarious German foreign exchange reserves. Other devices aimed at improving the position of Germany relative to its external trade included the

Aski trading technique and the granting of special exchange rates to German exporters in connection with exports deemed to be "additional". The Aski system involved unilateral agreements whereby foreign sellers agreed to accept payment in special mark accounts, which in turn were usable only for the purchase of specified German goods or services on terms established by the German exchange authority. The terms on which Aski marks were usable depended to a considerable degree on the urgency of Germany's need, typically in reference to the preparation for war, for the imported goods for which these marks were granted. For example, Aski marks credited to a foreign seller of goods of a military nature might be usable for the purchase of a wide variety of German goods at a rate of one Aski mark to two domestic marks. On the other hand, Aski marks granted to sellers of less essential commodities might be usable to acquire a relatively small numer of types of German goods at a rate of one Aski mark to one domestic mark. This would mean that a seller of essential goods to Germany could acquire twice as much of the same commodity as a seller of goods deemed to be non-essential and in addition could acquire a wider variety of German commodities. Additional exports were stimulated by granting exchange to specific German exporters on relatively favorable terms in cases in which they could not compete internationally with other sellers of the same goods at the normal rate of exchange. The term "additional exports" referred to German goods which could not be sold in the international market at a profitable price to the German producer at the regular exchange rate. Since such exports produced additional foreign exchange for Germany, the proceeds from their sale at competitive international prices were converted into German currency at a rate which provided mark proceeds adequate to produce a profitable return to the German seller.

It is reasonable to conclude that the original incentive for the

adoption of exchange controls by Germany was the necessity of protecting its precarious balance of payments position, particularly in connection with the effect of large scale capital movements. Following the ascendancy of Hitler and the emergence of preparation for war as the almost exclusive objective of German economic policy, exchange controls were motivated by the necessity of improving the international trade position of Germany for this purpose. The German control procedures in the 1930's represent probably the best example of the extremes to which controls may be carried in the interest of furthering particular national objectives.

It is appropriate to briefly mention the emergence of exchange control in the 1930's in South America, particularly because of some of the unique features of at least two examples thereof.

Argentina employed exchange controls which in essence were similar to those used by Germany. Thus, there was originally a virtual monopoly of the exchange market by the government. All foreign exchange realized from dealings in the more important export commodities had to be surrendered to the exchange authority at the official buying rate established by the exchange control authority. In turn, exchange was made available for preferred purposes at a higher selling rate (in terms of Argentine pesos per dollar). The margin between the official buying and selling rates provided a profit to the exchange authority, thereby augmenting government revenues. As is typical under controlled prices, a black market soon emerged in which foreign exchange transactions took place at rates other than those established by the exchange control authority. In the early 1930's, the Argentine government combated the existence of this black market, but by 1933 it had been accorded recognition as a legal free market, in which exchange derived from specified sources could be sold and exchange required for certain purposes could be acquired. This feature of the parallel existence of controlled and free markets was sharply different from the German situation.

The second feature of the Argentinean procedure meriting mention was the manner in which the type of transactions which were channeled into the official as compared with the free market was determined. Basically the decision was motivated by the desire to extend preferential treatment to trade transactions with particular countries or, to put it another way, to discriminate against transactions with certain other countries. Thus, most imports from the United States had to be settled in the free market where the exchange rate was typically approximately ten to twenty per cent above the official rate which was employed to settle transactions with preferred trading countries, notably Great Britain. As an example of the effect of this discrimination, assume that an identical item could be acquired from the United States at a price of twelve dollars or from Great Britain at a price of three pounds at a time when the dollar-pound rate was four dollars to one pound. If dollars and pounds could be acquired on the same terms for Argentinean pesos, there would be no advantage pricewise as between purchase from the United States or Great Britain. However, in a situation in which dollars had to be acquired in the free market while pounds were available at the official rate, the effective price of the particular item in terms of pesos would be about twenty per cent more if it was to be paid for in dollars than if it was of British origin. This discrimination was accentuated, when the gap between the free and official rates narrowed in the late 1930's, by the imposition of an exchange surcharge of twenty per cent with a credit for the excess of the free market rate over the official rate. When this did not turn out to be discriminatory enough in the eyes of the preferred trade partners, direct import quotas were placed upon goods of United States origin. This emphasizes the manner in which control of foreign exchange availability and rates may be employed to produce the same effect on international trade as tariffs which

are applied on a discriminatory basis. Thus, the Argentinean exchange control procedure presents an excellent example of the way in which control can be employed to create discrimination in favor of or against trade with particular countries.

As a contrast to the Argentinean procedure of discriminating as between various countries, Chile followed the practice of discriminating as between various commodities regardless of the country of origin. Thus, super-essential imports were paid for with exchange granted at a preferred rate, with less essential imports receiving less favorable treatment, and exchange for non-essential imports and financial transactions either being denied entirely or made available in sharply limited amounts. Similarly preferential treatment was accorded certain Chilean industries by regulation of the percentage of exchange becoming available from exports which must be surrendered to the exchange authorities at an exchange rate which is substantially lower than the official rate which applies to the balance of exchange proceeds. Variation of the percentage of exchange which must be surrendered at the lower rate produces a large number of effective exchange rates. A brief example of the operation of a multiple exchange rate system will serve to make its discriminatory aspects more clear. Assume that the official exchange rates provide for the sale of dollars to importers of essential drugs at a rate of thirty pesos per dollar while dollars are made available to importers of luxury goods at a rate of one hundred and forty pesos per dollar. It is apparent that a given number of pesos will purchase almost five times as much (in terms of dollar value) of drugs as of luxury goods thus operating to sharply discourage the import of luxury goods. If the exchange control authority buys dollars representing the proceeds from the export of copper at a rate of twenty pesos per dollar and at the same time pays fifty pesos for each dollar resulting

from the export of nitrate, it is apparent that the same dollar proceeds from an export shipment will produce two and one-half times as much local currency for the nitrate exporter as for the seller of copper.

Reference to the present schedule of Chilean exchange rates presented on pages 153-4 will provide specific illustrations of a multiple rate exchange rate structure.

The preceding paragraphs have presented a brief summary of the principal forms in which exchange control emerged in the 1930's. It must again be emphasized that this discussion does not pretend to represent a complete picture of the many forms taken by government intervention into the free operation of the foreign exchange market. Rather it is intended to present a more or less general perspective of the exchange control procedures which were introduced in the 1930's.

Purposes of Exchange Control - Pre-World War II

It is now appropriate to summarize briefly the reasons which lay behind the rather broad emergence of exchange control, as a guide to the understanding of controls as they exist at the present time and as a clue to the future of controls. It is reasonable to conclude that the fundamental motivation for the adoption of exchange control was the necessity of preserving some degree of balance in international payments, and in particular to avoid large and rapid movements or "flights" of capital. This objective gave rise to the necessity for direct control of the supply of and demand for exchange as well as outright prohibition on capital movements. In many respects, the foreign exchange position of a particular country may be compared with the balance in a bank account. Deposits in the account result from the proceeds of exports and from foreign investment and loans, while withdrawals from the account are made to pay for imports and as a result of the withdrawal of foreign capital and the

repayment of foreign credits. If a particular country experiences a continuing excess of imports over exports or is faced with substantial withdrawal of foreign capital, it is apparent that its foreign exchange position (bank account) will show a rapidly diminishing balance or even an overdraft. The avoidance of this situation is the motive for the adoption of exchange control for balance of payments purposes.

A related motive for the enforcement of direct control of the foreign exchange market was the maintenance of a rate of exchange different from that which would have emerged from the free operation of the market forces. Most commonly this involved the maintenance of exchange rates which overvalued the domestic currency in terms of foreign currencies. This often resulted, as illustrated by the case of Germany, from a fear that rapid and substantial downward movements in the external value of the currency, such as would accompany large scale capital movements, would create psychological forces creating similar feeling toward the internal value of the currency leading to domestic inflation. Many European countries in particular were concerned with this possibility, having experienced the chaos accompanying runaway inflation in the 'twenties. In addition the maintenance of an overvalued rate of exchange has the effect of improving the "terms of trade" of the country which is overvaluing its currency in terms of foreign currencies. In other words with an overvalued rate the amount of imports which can be acquired with a given quantity of exports is increased. For example, if an exchange rate of ten foreign currency units to one dollar is maintained as an official parity by the exchange control authority, foreign goods with a price of one thousand currency units would purchase one hundred dollars worth of goods of United States origin. If however, the exchange rate was allowed to move to twenty foreign currency units to one dollar, one thousand currency units in foreign

goods would produce only fifty dollars in American goods in exchange. While less common than the opposite case, the maintenance of a rate of exchange which undervalues the domestic currency may be motivated by a desire to minimize the possible necessity of subsequent devaluation with the attendant possible inflationary effects. The maintenance of an undervalued domestic currency, in terms of foreign currencies, will tend to increase the demand for goods for export. The production of export goods creates income without the related goods being available domestically to absorb such income with the result that inflationary pressures are introduced into the domestic economy. In many ways the situation is similar to that which results from the production of war goods. In order to minimize such inflationary pressures, some countries, notably Brazil, have required the compulsory investment of stipulated percentages of the proceeds of export transactions in government securities. This is very similar, in terms of economic policy, to the vigorous promotion of the sale of government securities to the public during a period in which war or defense expenditures are substantial. Obviously, the maintenance of undervalued exchange will produce the opposite effect on the terms of trade of the undervaluing country as compared with the results of overvaluation outlined above.

While the objectives discussed in the preceding paragraph represent the fundamental reasons underlying the adoption of exchange controls, in particular the original introduction of such controls, a wide variety of auxiliary motives are often present which have influenced the form of controls as well as the extension of the original form of control to new areas. The use of controls to discriminate between trade with various other countries was mentioned above in the discussion of the Argentinean techniques. Discrimination between various commodities, both in terms of favorable treatment of particular domestic industries as well as the granting of

preferential treatment to certain imports, may be an important objective of controls, particularly where the control system is characterized by multiple exchange rates or the simultaneous existence of controlled and free markets. The augmentation of government revenues resulting from government monopoly in foreign exchange dealings with a spread between the official buying and selling rates may be a significant factor in the control process. Several South American countries have employed exchange control including the monopoly and "price" control features to obtain exchange at favorable prices for use in meeting obligations resulting from foreign held government debt. In its extreme form, as illustrated by the German procedure, control of the foreign payments mechanism may be a segment of complete control of the domestic economy, with preparation for war as a fundamental motive.

The preceding pages indicate that the forms which exchange control have taken, as well as the underlying reasons for such control have been many and diverse. When we turn to an examination of the present status of exchange controls, it will be noted that the fundamental reasons for the adoption of controls, as well as the various forms which controls may take are much the same at the present time as was the case in the 'thirties.

It seems to be appropriate to make no attempt to examine the course of exchange control during the World War II period, since the form and purpose of controls during this period was directed toward maximizing the effective prosecution of the war effort. The necessity for government intervention in the operation of the internal as well as the external economic relationships of all countries required the extension and intensification of controls in the foreign exchange area. This necessity has undoubtedly had considerable influence on the status of controls during the post-World War II era.

Forms and Purposes of Exchange Control - Post-World War II

It will be recalled that one of the principal characteristics of foreign exchange control in the pre-World War II period was the diversity of form in which controls appeared as well as the variety of purposes accompanying their introduction and retention. This same situation characterizes the post-World War II era up to the present time. An indication of the variety of forms and purposes of exchange controls may be obtained from the following enumeration:

Instruments of Exchange Control

I. Government monopoly of dealing in foreign exchange.
II. Government disposition over private holdings of foreign exchange and assets.
III. Enforcement of an overvalued or undervalued rate of exchange.
IV. Multiple exchange rates.
V. Government permission to export or import.
VI. Government disposition over the proceeds of exports.
VII. Government allocation of exchange to imports.
VIII. Officially conducted bilateral clearing.
IX. Officially conducted barter.

Purposes of Exchange Control

A. Primarily with respect to international economic matters.
   1. To maintain exchange rate against depreciation or appreciation.
   2. To attain equilibrium in the balance of payments.
   3. To "permit trade to go on" without available foreign exchange.
   4. To secure more favorable "terms of trade".
   5. To control or force capital movements.
   6. To wage economic warfare.

B. Primarily with respect to domestic economic matters.
   1. To control inflation or deflation.
   2. To increase domestic employment.
   3. To foster industrialization, etc., i.e. "protection".
   4. To prepare for or wage war.
   5. To provide revenue for the state.
   6. To discriminate favorably or unfavorably with respect to certain persons or classes within the domestic economy.[1]

It must be emphasized that the forms of exchange control cited above are not mutually exclusive. Thus, government monopoly of dealing in foreign

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[1]Howard S. Ellis, "Exchange Control and Discrimination", The American Economic Review, (December, 1947), pp. 877-888.

exchange is essential to successfully impose several of the other forms of control such as the effective enforcement of exchange rates differing from those which would prevail in a free market. Likewise, there is substantial relationship between the various purposes of exchange control. For example the enforcement of exchange rates which have as their purpose the protection of a particular industry automatically involves discrimination in favor of this industry and against the remainder of the domestic economy.

As was the case in the 'thirties, the fundamental reason for the retention of exchange controls in the post-war period was (and is) to attempt to correct a condition of imbalance in the foreign receipts and payments position of the country employing controls. This was particularly true of countries which had suffered considerable destruction as a result of the war and hence were in need of imports in substantial quantities and at the same time were not immediately equipped to export in any large volume. This imbalance was intensified until September, 1949, in many cases by the enforcement of exchange rates which substantially overvalued the domestic currency and hence placed the particular country at a competitive disadvantage in international markets. That the protection of the balance of payments position represents the basic motivation for the adoption and retention of controls is indicated by the following statement, which also points out some of the other reasons for the retention of controls.

> Almost all member countries consulting the Fund held that the restrictions which they maintained were necessary for balance of payments purposes. Within this broad concept, however, the actual purposes varied greatly, reflecting the differences in individual country situations. Most countries felt that there was need to restrain over-all import demand, and frequently to discriminate in the application of their restrictions. The inconvertibility of many currencies, the inadequacy of available reserves, the fear of capital flight, and the persistence of dollar deficits in balances of payments were repeatedly stressed. Some countries also noted various difficulties in achieving and maintaining a unitary rate of exchange which would make possible large scale removal of restrictions. In certain cases, consulting members indicated that

their restrictions, particularly in their discriminatory aspects, were associated with their participation in group arrangements. Some members said that the desire to avoid accumulating inconvertible currencies was an additional reason for the need to discriminate; in some cases, as where it was desired to avoid introducing or intensifying administrative restrictions, such discrimination was achieved by permitting broken cross rates.

Some countries indicated that, while using restrictions to cope with balance of payments difficulties, they also tried to apply them in such a manner as to serve other subsidiary purposes. For example, a number of countries with economic development programs argued that, since they could not finance imports of all types, they allocated available exchange in such a way as to make sure that the needs of the programs were met. Similar arguments were advanced in defense of exchange control policies designed to help achieve certain social and political objectives, such as those related to distribution of income and maintenance of high levels of employment. Some raw material exporting countries argued that exchange reserves had to be protected against the contingency that their export proceeds might be reduced in the future, and that in such an event it would be desirable to have resources available to maintain the flow of development goods.

Some consulting countries stated that their restrictions served other than balance of payments purposes. Thus, certain specific restrictions on imports were stated to be used to protect domestic agriculture and infant industries. Similarly, for many countries an important consideration was the maintenance of existing export industries selling in soft currency markets, even though this intensified the use of discriminatory import policy and bilateralism. For some countries with multiple exchange rates, their representatives indicated that these practices were substitutes for taxes, subsidies, or tariffs.[2]

The preceding statement, which summarizes the findings of the International Monetary Fund in its conferences with member countries regarding the possibility of the removal of exchange restrictions, serves to reemphasize the wide diversity of purpose motivating the adoption and retention of exchange control procedures of various types.

It is now appropriate to examine the specific forms in which foreign exchange controls are manifested at the present time, and to illustrate the use by various countries of the forms of controls which are important relative to the accounting for and reporting of foreign operations. Before

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[2]International Monetary Fund, Fourth Annual Report on Exchange Restrictions (Washington D.C., 1953), pp. 3-4.

examining specific control mechanisms, it is essential to emphasize that exchange controls, like other economic controls imposed and enforced by government action, are subject to frequent revision. The exchange control techniques described in this section reflect the most recent information available to the writer. It must be recognized, however, that changes in the details of control procedures may occur at any time, and for this reason there exists the possibility that the procedures described in this section may already have been altered. It is probable, however, that such changes as may occur deal principally with details of the control program rather than with the essential methods and objectives. It must also be recognized that there exists the possibility of modifying the formally established control regulations by means of special contractual arrangements between particular American corporations and the specific foreign country involved. Conversation with the employee responsible for foreign exchange problems in one of the large American oil producing companies indicated that arrangements relative to exchange restrictions imposed by foreign countries were handled on the basis of negotiations between the country involved and representatives of the American company.[3] It is apparent that the possibility of the existence of special arrangements with a particular American corporation tends to lessen the reliability of the conclusions which may be drawn from an investigation of the formally established regulations relating to exchange control. It will also be noted in the succeeding section that quite frequently control is exercised by means of the exchange control authority reserving the right to approve or disapprove individual transactions involving foreign currencies. This type of control quite obviously operates to create the possibility of a considerable degree

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[3]Standard Oil Company of California.

of variability as to the impact of control on a particular type of transaction. This variability may operate over time as well as in relation to the treatment accorded transactions involving different countries or different products at the same time. In the discussion of the formal exchange control regulations which follows, the possibility of the modification thereof by means of special agreements as well as by means of varying application in specific cases of the formally prescribed regulations must be kept in mind.

Illustrations of Specific Exchange Control Procedures

In the paragraphs which follow, several illustrations of specific exchange control techniques will be presented. No attempt has been made to include a complete presentation of currently employed control procedures in all countries, but rather only to present the major aspects of control in those countries which are most important in relation to foreign operations by United States corporations. One of the most important of these countries, Canada, will not be mentioned because at the present time it does not impose any formal exchange controls. The discussion will be classified in terms of the particular form in which controls appear, rather than on the basis of the countries in which controls are employed.

Restrictions on the Convertibility of Foreign Currencies

A characteristic feature of exchange control in every country in which controls exist is some degree of limitation on the convertibility of domestic currency into other currencies for the purpose of transmitting funds away from the country imposing the restrictions. For the purposes of this discussion, restrictions on the convertibility of foreign currencies into United States dollars represent the significant aspect of controls of this type. In general, restrictions on convertibility and the accompanying transmission of funds in dollars to the United States fall into two

categories, with considerable difference in the type and severity of restrictions relating to each. These categories include restrictions on the withdrawal of capital from the foreign country and restrictions on the transmission of earnings or profits. It seems apparent that from the point of view of the impact on the reporting of foreign operations the existence of restrictions on the transmission of current earnings to the United States parent corporation is by far the most significant. In fact, when it is recognized that the going concern point of view presumably underlies corporate reporting in general, it appears that restrictions on the withdrawal of capital would be of little significance. In the discussion which follows, however, restrictions on the withdrawal of both capital and earnings will be examined.

United Kingdom

The exchange control procedures in effect in the United Kingdom relating to restrictions on the convertibility of the Pound Sterling are summarized below. It should be recognized that the United Kingdom exchange control area embraces what is now described as the Scheduled Territories (formerly known as the Sterling Area) which include the United Kingdom and the Dominions (except Canada), the other countries in the British Empire, and certain non-British Empire countries such as Iceland, Iraq, and Libya. Convertibility restrictions apply to transactions between this area and the remainder of the world, but are not applicable within the Scheduled Territories.

Restrictions on the withdrawal of capital vary according to the date on which the capital investment was made. Investment made prior to January 1, 1950, may be withdrawn only with specific permission of the exchange control authorities and most commonly application for such permission will result in the funds involved being directed to a Blocked

Sterling Account. Blocked Sterling Accounts may be used only for the purpose of reinvestment in sterling securities not maturing earlier than ten years from date of purchase. New capital investment in the United Kingdom by non-residents after January 1, 1950, in projects approved by the exchange control authorities may be repatriated at any time thereafter to the extent of the original investment and from the proceeds of that investment. It is essential that approval of the investment project by the exchange control authorities be received before the investment is made in order for the capital involved to be readily subject to withdrawal.

In regard to the remittance of dividends representing the distribution of earnings on investment by non-residents, it must be noted that an exchange license is required for all payments to countries outside the Scheduled Territories on account of invisibles. The term "invisibles" refers to payments for other than commodity imports. Examples would include insurance premiums, interest payments, remittance of earnings, etc. Payments required under contractual arrangements made prior to September 3, 1939, and under contracts entered into with the approval of the exchange control authorities since that time are usually permitted without discrimination as to the recipient country. Each application for exchange for non-contractual payments is oonsidered on its own merits and may be subject to limitation as to the amount of exchange granted, with the additional possibility of discrimination according to the recipient country. The following statement apparently represents the current situation regarding the remittance of dividends by subsidiaries of American corporations:

> Income by way of interest, dividends, etc. on investments in the United Kingdom may be credited with little formality to American and other non-resident accounts (or remitted in dollars, etc.) in favor of the beneficial owner. This provision enables transfer of dividends declared out of profits earned by American-owned subsidiaries, but specific approval is required in each case.[4]

In summary, it appears that present United Kingdom exchange control regulations permit the remittance of dividends representing a distribution of profits, although an exchange license is granted only after consideration of the facts of each case. The transfer of capital is subject to a considerably greater degree of restriction, particularly in the case of capital invested prior to January 1, 1950. It is appropriate to mention that in the case of an American oil producing and distributing corporation the United Kingdom exchange control authorities have permitted the remittance of United States dollar costs of operations and average annual profits.

France

At the present time, French exchange control regulations permit the transfer abroad of the proceeds of the sale of investments made with the approval of the authorities after August 31, 1949. Proceeds of the liquidation of non-resident owned investments made before this date are credited to a Capital Account, the balance of which is usable only for the making of certain stipulated investments, payment of travel expenses while in France, and transfer to another Capital Account. It will be noted that, in essence, the French regulations pertaining to the transfer abroad of capital investments closely resemble the related restrictions in the United Kingdom discussed in the preceding section.

Current exchange control regulations in France permit the transfer of income accruing to non-residents in the form of profits, dividends, and

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[4]National City Bank of New York, Summary of Exchange and Foreign Trade Regulations as of January 1, 1953, (New York, 1953), p. 93.

royalties subject to the approval of the Office des Changes in each case. Special arrangements may be made with specific American corporations granting a portion of the profits from foreign operations in dollars and a portion in francs, with discrimination as to the percentages dependent on the type of product involved in the particular case.

Sweden

Restrictions on the transfer of capital or profits from Sweden to other countries are presently more stringent than those described above. The transfer of the proceeds of the sale or liquidation of foreign-owned securities is prohibited. Exceptions permitting the repatriation of moderate amounts are granted only in exceptional cases. "Income of subsidiaries or affiliates of American companies may be transferred to the United States only with the approval of the Exchange Office, and each case is determined on its own merit."[5] In this connection, the Exchange Office has been particularly rigid in approving remittances of profits in United States dollars. Under these circumstances, a fairly common practice in the last several years has been to obtain Sterling in lieu of dollars and to use this for the acquisition of raw materials and the payment of costs where this could be accomplished with Sterling.

Brazil

Present exchange control regulations in Brazil require the registration of foreign investments in Brazil with the Special Registry of the Exchange Department of the Bank of Brazil. Transfer of capital and of earnings on capital is permitted only when such registration has occurred. In addition, registration with the Superintendency of Currency and Credit is required in order to obtain priority in the acquisition of exchange for remittance of earnings. Prior to February 21, 1953, transfers of both

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[5] Ibid, p. 83.

capital and earnings were regulated by the exchange allocation or rationing system operated by the Bank of Brazil. Under these regulations applications for the transfer of foreign invested capital up to twenty per cent of such capital in any one year were classified in the Fifth Category (which is the last classification) for purposes of allocation of exchange. At the beginning of 1953, transfers of funds classified in this category were largely in suspense. Project of Law #1,041-D, which became effective on February 21, 1953, provided for the creation of a free exchange market to operate parallel with the official market. Transactions involving foreign capital and earnings are now transacted in this market at the rate of exchange established therein and are exempt from exchange licensing. Presumably, this involves a substantial loosening of restrictions on the transfer of foreign capital.

Prior to February 1, 1953, the transfer of earnings on foreign investments was permitted up to an amount equal to eight per cent of the value of the registered capital, with any excess over this rate being treated as a capital transfer. Transfers of earnings within this limit were classified in the Second Category, which follows the Preferential and First Categories, for the purpose of exchange allocation. As was mentioned above in regard to capital movements, present regulations involve the acquisition of exchange for the purpose of profit remittances in the free market without the necessity for obtaining an exchange license. Apparently, this involves the elimination of the eight per cent limitation on the remittance of dividends by American owned subsidiaries. However, the obtaining of exchange in the free market for the purpose of the remittance of dividends involves a substantial penalty in comparison with the official market rate. On September 9, 1953, the dollar value of the Brazilian cruzeiro on the free market was $.0265 as compared with the official value of $.0550.

Argentina

Exchange control in Argentina is characterized by an elaborate multiple exchange rate system, combining various official rates with the rate established in a parallel free market. At the present time any remittances of foreign capital or earnings thereon which may be permitted by the Central Bank are handled at the free market rate. Approval of the Central Bank must be obtained for any outgoing capital transfer and such approval has apparently not been forthcoming for some time, particularly in regard to dollar remittances. The exchange regulations provide for the transfer of net profits on foreign investment for fiscal years closing after August 28, 1950, but again the specific approval to actually consummate such transfers is not presently being granted. No provision is made in the exchange regulations for the transfer of profits for fiscal years closing prior to August 28, 1950. The Argentinean situation regarding the transfer of profits on foreign owned investments is an excellent example of a marked difference between the formally prescribed regulations and the conditions which actually are in existence at a particular time.

The examples presented in the preceding pages of limitations on the free convertibility of foreign currencies do not pretend to represent a complete catalogue of the restrictions which are in existence at the present time. Rather, it is felt that the illustrations which were chosen present a satisfactory cross section of the present status of convertibility limitations. A few observations are in order in the nature of a summary of restrictions on foreign currency convertibility. In the first place, it is important to note that limitations on convertibility are found in one form or another in every country which imposes exchange control. Secondly, it will be recalled that restrictions on the conversion of foreign currencies for the purpose of making international transfers of

capital are typically much more stringent than restrictions dealing with the transmission of current earnings. This severity of regulation regarding the withdrawal of capital is in turn particularly marked in the case of capital investments made before and immediately following World War II, as compared with the treatment accorded investment made in the last few years with specific approval of the appropriate government agency. Finally, it must be recognized that the actual practice regarding limitations on the convertibility of foreign currencies for the purpose of transmitting either capital or earnings may differ rather sharply from the formally prescribed regulations, usually in the direction of being more severe. Thus, the formal exchange control regulations may prescribe procedures for the withdrawal of capital or earnings, with permission of the appropriate regulatory agency being required to actually effect a particular transfer. Obviously, such provisions are meaningless if the required permission is consistently denied.

The impact of restrictions on the convertibility of foreign currencies on the reporting of foreign operations will be considered in a subsequent section of this chapter, following the illustration of other forms in which exchange control is manifested at the present time.

Multiple Exchange Rates

The concurrent existence of several exchange rates is a common, although not universal, characteristic of exchange control programs. The degree of multiplicity may vary widely, ranging from the employment of separate buying and selling rates to the use of an elaborate array of differing rates which are applicable to particular types of foreign currency receipts or payments. The purposes behind the use of multiple exchange rate schemes are many and various. The existence of a margin between the rates at which an exchange control authority will buy or sell a particular

foreign currency is typically motivated by the objective of augmenting governmental revenues, perhaps for the purpose of defraying the cost of operating the exchange control administration. The prescription of a variety of exchange rates for differing foreign receipts or payments may have one of several purposes. One of the most important is to assist in the program of conserving a scarce supply of foreign exchange by providing for the payment for various imports at progressively discriminatory rates depending upon the essentiality of the particular commodity or service being imported. It must be noted that the definition of what represents an essential import is commonly related to economic development programs in a particular country thereby integrating the exchange control mechanism with domestic economic policy. Thus, imports of heavy machinery or other capital goods may be paid for with exchange acquired at relatively favorable rates as compared with consumption goods. Favorable rates may also be provided to make possible the acquisition of exchange at such rates for the purpose of making government payments abroad, particularly interest and principal payments on foreign held debt. The use of multiple buying rates may be motivated by the desire to extend particularly favorable treatment to certain domestic industries, either to encourage the development of new (infant) industries or to promote expansion in established areas. In some cases, the granting of especially favorable buying rates to proceeds from the sale of particular commodities may be necessary to permit these commodities to compete in the world market. It will be noted that the use of multiple exchange rates on either the buying or selling side may actually be a substitute for import or export duties directed at particular classes of commodities. Another form of multiple exchange rates which is actually only a variant of those described above is the concurrent existence of both official or controlled rates and free market rates, with particular receipt

and payment transactions being channelled into one or the other of these markets dependent upon the desire to make exchange available for the particular transaction at a favorable or unfavorable rate.

An excellent example of the use of multiple exchange rates is available in the case of Chile. As the tabulation below indicates, the Chilean scheme involves the parallel existence of controlled rates and fluctuating free market rates, buying as opposed to selling rates, as well as the required application of various of these rates, or combinations thereof, to particular foreign payment and receipt transactions. The following table summarizes the status of Chilean exchange rates as of December 31, 1952:[6]

(pesos per U. S. dollar)

Buying	Selling
19.37 Sales of exchange by the large mining companies (copper and iron) to cover legal cost of production; sale of approximately 2% of the proceeds of exports of nitrate and iodine.	
31.00 Liquidation of insurance and certain government receipts	31.10 Imports of drugs, sugar, newsprint, tallow, and certain government imports. Certain invisible foreign trade items.
43.00 Certain invisible foreign trade items.	43.10 Imports of raw cotton and a few other articles.
49.85 (35% at P31 and 65% at P60) Exports of untanned hides, skins, and wool.	

[6]International Monetary Fund, op. cit., pp. 98-99.

Buying	Selling
50.00	50.10
Exports of nitrate and iodine (first half 1952).	Imports of wheat, rice, gasoline, ships, etc. Certain invisible foreign trade items.
60.00	60.10
Exports of certain agricultural products (barley, kidney beans, soapbark, timber) and of copper and bronze scraps. Sales of exchange by large mining companies (copper and iron) to cover local currency expenses for new investments in the country. Exports of nitrate and iodine (second half 1952).	General import rate, including crude oil, tea, yerba maté, paraffin, antibiotics, kerosene, rubber, jute, cellulose, industrial and agricultural machinery, etc.
71.60 (80% at P60 and 20% at Free Market Rate)	
Export of beans.	
89.00 (50% at P60 and 50% at Free Market Rate)	
Export of lentils.	
118.00 (Banking Free Market Rate)	118.00 (Banking Free Market Rate)
Medium and small mining, agricultural, and industrial exports, crude petroleum, and private capital.	Machines and tools, chemical products, etc. Profits and dividends of foreign capital.
128.50 (Nonbanking Free Market Rate)	128.50 (Nonbanking Free Market Rate)
Travel receipts.	Travel expenses.
138.00 (Banking Free Market Rate plus P20 per U.S. $1)	138.00 (Banking Free Market Rate plus P20 per U.S. $1)
Wine exports.	Certain specified luxury imports.
155.00 (Fluctuating Rate)	155.00 (Fluctuating Rate)
Exports of newly mined gold.	Certain specified luxury imports.

The preceding tabulation exhibits an extremely wide variation of rates applicable to various specified receipt and payment transactions. In

general, the multiple rate system provides for favorable terms for the conversion of dollars into pesos for the proceeds of the export of specified Chilean products thereby effectively creating the equivalent of an export duty on those products to which the lower peso-dollar rates apply. On the selling side, favorable rates are provided for the acquisition of dollars for the purpose of making payment for imports considered to be essential to the Chilean economy, with progressively less favorable rates being applicable to less essential import transactions.

Numerous other illustrations of the employment of multiple exchange rates could be cited, particularly in the case of South American countries where this procedure has achieved general adoption. For the purpose of this discussion, however, only one other illustration will be presented, that of Austria. This example has been chosen in order to illustrate a less complex rate pattern than that of Chile and also because it is drawn from a different geographical area. The following tabulation summarizes the December 31, 1952 exchange rate structure of Austria:[7]

(schillings per U. S. dollar)

Buying	Selling
21.30	21.42
Exports and specified commercial invisibles	Imports and specified commercial invisibles.
25.87	26.13
Other invisibles and capital.	Other invisibles and capital.

The preceding exchange rate schedule is characterized by the existence of only two rates with a relatively narrow differential. The higher rate is largely technically applicable to capital transfers which are

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[7] Ibid, p. 62.

subject to stringent control based on the conditions of each case, and in fact are completely prohibited in the case of "old" capital. In effect, the lower rate is the only one of general importance in relation to the bulk of foreign payment and receipt transactions. It will be noted that a small differential exists between the buying and selling rate providing a "gross profit" which accrues to the exchange control authority.

Having examined the fundamental objectives of exchange control and the forms which control has taken, both in general as well as by the presentation of specific control measures as they are employed by particular countries, it is now appropriate to turn to an evaluation of the impact of exchange control on the problems related to the reporting of foreign operations.

Impact of Exchange Control on the Reporting of Foreign Operations

The following discussion relating to the impact of exchange control on the reporting of foreign operations will employ the same sequence of presentation which was employed in the preceding section in which the forms of exchange control were surveyed. Hence, the first matter requiring attention is the effect of the existence of restrictions on the convertibility of the foreign currency into dollars.

Restrictions on Convertibility

The existence of restrictions on the convertibility of a foreign currency raises the following questions relative to the reporting of foreign operations:

(1) Is it appropriate to make any attempt to translate foreign currency balances into dollars in a situation in which convertibility is restricted or completely prohibited?

(2) Is it satisfactory reporting procedure to include unremitted income of a foreign subsidiary in the earnings of the domestic parent company in view of restricted convertibility of the foreign currency?

(3) Is it appropriate to include the accounts of foreign subsidiaries domiciled in countries in which convertibility restrictions exist in consolidated financial statements?

The first two questions cited above will be discussed in this chapter and the third will be dealt with in the succeeding chapter where the problem of the consolidation of the accounts of domestic and foreign corporations is considered in detail.

In connection with each of the above questions, it is essential to consider the impact of the two facets of restrictions on foreign currency convertibility which are significant from the point of view of reporting foreign operations, namely restrictions on the remittance of capital as opposed to restrictions on the remittance of current earnings. It will be recalled from the discussion in an earlier section of the present chapter that restrictions of the first type are much more common and likely to be much more severe than those in the second category.

Upon turning to the first question posed above, it is difficult to visualize how restrictions on currency convertibility for the purpose of transmitting either capital or earnings to the United States should render inappropriate the translation of foreign currency balances into dollars. The objective of such translation would presumably be to permit the determination of the dollar equivalent of foreign currency net assets. The amount so determined might then be compared with the dollar cost of the investment or employed for other quasi-statistical purposes. As was mentioned in Chapter I, conditions may exist which render any translation of

foreign balances meaningless or even misleading, but it does not seem appropriate to include convertibility restrictions which may be in existence at a particular time in this category. Rather, it would seem that a complete absence of trade relationships in any form and the related lack of currency convertibility for any purpose, including transactions related to normal import-export operations, would be necessary to render translation of foreign balances inappropriate. It must be understood that at this point only the appropriateness of translation is under consideration. The validity of employing the results of the translation process in terms of incorporation of translated balances in statements of the parent corporation or in consolidated statements will be the subject of the discussion which follows in this and the succeeding chapter.

The second question set forth above poses a considerably more difficult problem, the solution to which, assuming that it is possible to reach "a" solution, requires substantially greater consideration. In brief, the question relates to the propriety of the inclusion in the earnings of a domestic corporation of undistributed income of a foreign subsidiary when restrictions on the remittance of foreign earnings exist. Most commonly, on the reporting level, this problem is associated with the problem of the propriety of consolidating the accounts of a foreign subsidiary with those of a domestic parent company. Since the question of consolidating foreign subsidiaries will be considered in detail in the next chapter, the question of recognizing unremitted foreign income will be considered at this point apart from the consolidation problem. As a hypothetical example, let us consider the following data. The American Corporation organized a foreign subsidiary on January 1, 1953, by the investment of $50,000. During the year ended December 31, 1953, the net income of the foreign subsidiary, expressed in dollars by application of the translation procedures discussed

in Chapter II, was $10,000 and no dividends were remitted to the American Corporation. If the American Corporation follows the practice of carrying the account on its records representing the investment in the foreign subsidiary at cost, no problem relative to the recognition of unremitted foreign earnings arises other than that which might be created by extending this illustration to include the problem of consolidating the accounts of the foreign subsidiary with those of the American Corporation. If, however, the American Corporation desires to carry the investment account at an amount equal to the dollar net assets of the foreign subsidiary, the problem of dealing with unremitted foreign earnings enters the picture. The application of the equity or accrual method of carrying the investment account would require the addition of $10,000 to the investment account and presumably the inclusion of a like amount in the income account of the American Corporation. It is then necessary to evaluate the propriety of including unremitted subsidiary earnings in the parent company income account if the availability of such earnings to the parent is limited because of the existence of restrictions on the free convertibility of the foreign currency.

It is desirable, as a part of formulating principles which may provide a general guidepost in the area of recognition of restricted unremitted foreign earnings, to consider the procedure which would be appropriate in a comparable situation involving a domestic subsidiary corporation. If we ignore the legal implications of the calculation of the amount of parent company earnings available for dividends, there would seem to be no serious objection to including in the parent company's earnings the parent's equity in undistributed domestic subsidiary profits. This is true although there exists in every such case limitations on the amount of subsidiary assets which can be transferred to the parent company. In the general case such

limitations take the form of legal restrictions on the amount of subsidiary assets which can be transferred to the parent corporation as dividends. In every jurisdiction the applicable state corporation code includes provisions which limit the power of a corporate entity to declare and pay dividends which represent a return of capital. It must be recognized that the severity of such restrictions varies substantially as between the several states and that certain exceptions to the prohibition of capital dividends do exist.[8] However, it seems quite appropriate to conclude that, by and large, the power to return invested capital to stockholders is not an inherent right of a corporate entity, except in a liquidation situation. Since we are presumably concerned in this inquiry with problems of financial reporting for a going concern, it seems reasonable to exclude the liquidation case from our consideration. Hence, it appears reasonable to conclude that there is considerable similarity between foreign exchange restrictions which limit or prohibit the convertibility of foreign currency capital into dollars and legal restrictions on the disbursement of dividends representing a return of invested capital in a domestic situation. There is certainly no general feeling on the part of accountants that restrictions limiting the power of a domestic corporate entity to distribute capital dividends should cause the inclusion of undistributed subsidiary earnings in the earnings of the parent company to represent inappropriate reporting procedure. By the same token it certainly appears reasonable to conclude that restrictions on the free convertibility of foreign currency capital should have no effect on the propriety of the recognition by a domestic parent company of its equity in foreign profits. This conclusion would seem to be valid if either complete consolidation of the accounts of the domestic and foreign

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[8] As illustrated by the case of corporations engaged in the exploitation of wasting assets.

corporation or only recognition by the parent of its equity in subsidiary earnings, distributed or not, is the reporting objective. It must be emphasized that, to this point in the discussion, only the effect of restrictions on the convertibility of foreign currency for the purpose of transmitting capital have been considered. It is still essential to give consideration to the impact on reporting of restrictions on the transmission of earnings.

When we turn to a consideration of the effect of restrictions on dividend remittances on parent company recognition of undistributed subsidiary earnings, it is essential to recognize that the specific status of such restrictions is much less clearly defined than in the case of restrictions on capital movements. It will be recalled from the preceding discussion of the various forms of convertibility restrictions that restrictions on the remittance of earnings are subject to a substantial degree of variability and that reliance on formally prescribed regulations does not always represent completely satisfactory procedure. Limitations on the remittance of foreign earnings are frequently applied in consideration of the merits of each application for exchange for this purpose. In addition, it is reasonably common practice for individual American companies to make special arrangements regarding the transmission of profits which may create considerably different results from those indicated by the formal exchange control regulations. While this situation makes it very difficult to promulgate procedures which may be appropriately applicable to each specific situation, it is still possible to develop principles which are of general applicability relative to the recognition of restricted foreign earnings.

Before embarking on the examination of the problem of the impact of restrictions on convertibility of foreign currencies for the purpose of transmitting current profits to the United States, it is essential to

reemphasize that this problem is one which in its practical applications is most commonly associated with the question of the desirability of including the accounts of foreign subsidiaries in consolidated statements. For this reason, the following chapter will also be concerned with this problem and it is at that point that examples of current reporting practice in this connection will be presented.

Once again it is convenient to consider the essential similarity between a case involving a domestic subsidiary corporation and one involving investment in a subsidiary corporation domiciled in a foreign country. In both cases, it is reasonable to conclude that the concept of the going concern is a valid assumption underlying the preparation of financial statements. Also it is unquestionably true that consistency in the application of accounting or reporting principles, both in terms of consistency over time as well as consistency of treatment of similar problems at the same time, applies to the accounting for the investment in either a domestic or foreign subsidiary. Thus, it would not seem to be appropriate to insist upon the existence of conditions which would technically permit the remittance of all of the earnings of a foreign subsidiary in order to justify recognition of such earnings in the accounts of the domestic parent company, when in fact the retention of a substantial part of such earnings for use by the foreign subsidiary is practically necessary in order for the subsidiary to satisfactorily continue to operate. Also, from the point of view of consistency of treatment of similar problems which exist concurrently, it does not seem reasonable to apply one rule of thumb to the treatment accorded undistributed profits of domestic subsidiaries and an entirely different one to an essentially similar situation in relation to the earnings of a foreign subsidiary. To illustrate this point further, let us consider the case of a United States corporation which owns all of the

capital stock of another United States corporation, this stock having been acquired on the date when the subsidiary corporation was organized. After three years, the subsidiary corporation had accumulated a substantial balance in the retained earnings account, but had paid no dividends. Under these circumstances it would seem to be perfectly satisfactory reporting procedure for the parent corporation to reflect in its assets, periodic net income, and accumulated retained earnings the increase in the net assets of the subsidiary resulting from profitable operations. It is further assumed that the subsidiary has entered into a loan agreement with an insurance company, which, among other things, restricts a substantial portion of the retained earnings as to dividend payments. No evidence is available which indicates that under these circumstances it would not continue to be proper accounting and reporting procedure for the parent company to reflect the undistributed income of the subsidiary in its assets and stockholders' equity. At most, disclosure of the amount of the subsidiary undistributed profits which are restricted as to remittance to the parent company would be required. The situation would seem to be fundamentally the same in the case of a United States corporation with a subsidiary located in a foreign country in which there existed restrictions on the convertibility of the foreign currency for the purpose of remitting earnings. Consistent treatment of the similar situations would seem to permit the full recognition by the domestic parent company of undistributed subsidiary earnings in spite of the existence of restrictions on the transmission of funds. Again, the principal responsibility at the reporting level would seem to be satisfied by adequate disclosure of the presently existing restrictions on the transmission of funds from the foreign subsidiary.

When we consider the problem of consistent treatment of unremitted

foreign earnings over time, some modification of the conclusion expressed in the preceding paragraph appears appropriate, at least at first glance. It is readily apparent that there always exists the possibility of the deterioration of relations between the United States and any foreign country to the extent that no trade or financial transactions may be consummated. If this should take place, it is obvious that it would not be appropriate even to attempt translation of foreign currency balances, much less to incorporate undistributed foreign earnings in the computation of parent company net income. It follows that if it is considered essential to adopt accounting and reporting procedures which will be applicable under all conditions in the future, the only safe procedure is to refrain from any recognition of undistributed foreign earnings. This would be true even in the case in which there were no restrictions presently existing on the convertibility of a particular foreign currency, since the possibility of the imposition of restrictions in some degree is always present. This point of view would seem to represent an extreme position in terms of the observation of the principle of consistency and one which could lead to the placement of consistency higher on the scale of the accountant's objectives than accurate and realistic reporting of financial position and operating results.

Another basic concept which should be recognized in the process of formulating proper procedures regarding the recognition of unremitted foreign earnings is that of conservatism. There is little question but what the objective of achieving a maximum degree of conservatism in the reporting process has strongly influenced the form which so-called generally accepted accounting procedures have taken. While it is certainly true that the nature of the accountant's responsibilities in the area of financial reporting is such that some degree of recognition of the concept of conservatism

is appropriate, it seems reasonable to conclude that considerable damage has been done to the development of rational and consistent accounting techniques by excessive reliance on conservatism as a prime virtue. The generally recognized principle that all losses, realized or unrealized, should be given immediate recognition in the accounts but that gains should be recognized only when realized, is an excellent illustration of the inconsistent and illogical procedures which may emerge from excessive reliance on the sacredness of conservatism. The following statement illustrates the impact of the concept of conservatism on the issue now being explored:

> As to earnings, 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 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. In other words, the position shown should not be made better by the omission of foreign results.[9]

It is important to note that the above statement was originally made in 1939, when world conditions were becoming chaotic, but the same paragraph was repeated in November, 1949,[10] which would seem to indicate that the recommendations were of more or less permanent applicability and not entirely a result of the state of international affairs during the early years of World War II. It would seem that the preceding statement was motivated more by the objective of conservatism than by a desire to suggest procedures which would produce the most rational reporting of financial position and operating results.

Before reaching a conclusion as to the impact of restrictions on the remittance of foreign earnings on the recognition of unremitted foreign earnings by an American parent corporation, it is necessary to examine the

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[9] American Institute of Accountants - Committee on Accounting Procedure, Accounting Research Bulletin Number 4 - Foreign Operations and Foreign Exchange, (December, 1939).

[10] American Institute of Accountants - Research Department, op. cit., p. 4.

possible real effects of such restrictions. This necessarily involves inquiry into matters of financial policy or fund administration of the foreign affiliate. It seems essential to recognize that, in many situations, there may be no desire on the part of the parent corporation to withdraw any part of the assets generated by foreign profits. This result may emerge from a need for funds within the foreign subsidiary for increased investment in plant, inventories, or for the retirement of debt. This intention to reinvest foreign earnings is not infrequently given formal recognition in the accounts of the foreign subsidiary by means of a stock dividend. Under these circumstances it is difficult to visualize how restrictions on the transmission of assets resulting from foreign earnings should have any impact on the propriety of recognition of these earnings by the parent corporation. At the other extreme may be the situation in which a dividend equal to the amount of foreign earnings would be declared and remitted to the parent corporation in the absence of restricted convertibility of the foreign currency. Under these circumstances it seems apparent that the recognition of unremitted foreign earnings would be inadvisable. Quite apparently there may exist a wide range of situations between the two extremes cited above in regard to the real effect of restrictions on the withdrawal of foreign earnings. This leads to the conclusion that no general recommendation can be made as to the propriety of recognition of restricted foreign earnings by an American parent corporation; rather, a decision must be reached in each situation in recognition of the particular effect of convertibility restrictions on the freedom of administration of foreign assets. It is of the utmost importance that the existence of restrictions, per se, not be interpreted as requiring non-recognition of foreign earnings in a situation in which the real effect of restrictions is inconsequential. In essence, the problem of recognition of unremitted foreign earnings relates to the problem of valuation of the foreign

subsidiary as a going concern. Presumably this value, to the parent corporation, is a function of the magnitude of the future inflow of dollars from the foreign subsidiary. Once again it is reasonable to conclude that restrictions on the transmission of current earnings do not impair the long-run value of the foreign affiliate in a situation in which it is the intention to reinvest current earnings in expanded foreign operations in order to maintain or enhance the future earning power of the foreign subsidiary.

The preceding discussion leads to the following conclusions regarding the recognition by a United States corporation of earnings of a foreign subsidiary corporation in situations in which restrictions on the convertibility of the foreign currency exist. The existence of restrictions on the convertibility of the foreign currency for the purpose of transmitting capital funds to the United States should have no necessary impact on the recognition of unremitted foreign income. Disclosure of the existence of such restrictions on the statements of the parent corporation is appropriate, although when the restrictions relate exclusively to the remittance of capital, it would not appear that disclosure of such restrictions is mandatory. The existence of restrictions on the remittance of current earnings should not, as a general rule, cause the recognition of unremitted foreign earnings to be improper. It has been pointed out that the degree of restriction on the remittance of foreign earnings may vary widely and it is also apparent that particular situations in regard to the reinvestment of foreign earnings may exist which may justify modification of the general principle cited above. Consistent treatment of domestic and foreign subsidiary earnings at the same time would seem to be a much more important consideration than observance of consistency over time or insistence on conservatism as the most important reporting objective. Disclosure of restrictions on the remittance of current earnings in the statements of

the parent corporation where such earnings are reflected should be considered essential as a part of adequate reporting. It must be emphasized that, in an area in which conditions are subject to as much variability, both over time and as between various countries at one point in time, it is impossible to prescribe procedures of universal applicability. What is being suggested in this discussion may be considered as representing somewhat of a general guide to reporting procedures, with exceptions or departures therefrom being permissible and in fact on occasions desirable, but requiring justification based upon the facts of the particular case.

Multiple Exchange Rates

It will be recalled that the discussion in Chapters I and II which developed recommended procedures for the translation of foreign currency balance sheet and revenue and expense account balances assumed the existence of a single rate of exchange at a particular time. In the present chapter it has been pointed out that this happy situation frequently does not exist; rather, it is common to find a number of official exchange rates applicable to various types of transactions as well as the parallel existence of official and free market rates. When this situation exists, the question immediately arises as to which of the "family" of concurrently effective rates should be employed for the purpose of translating foreign currency balances into United States dollars. For the purposes of this discussion, the existence and possible use for translation purposes of "black market" rates will be ignored.

The illustrations of multiple exchange rate schedules presented earlier in this chapter indicated that, at least in essence, such schemes involve the prescription of exchange rates to be applied to the purchase or sale of exchange for the purpose of consummating specified commodity import or export transactions and a separate rate or rates relating to

financial transactions, such as the remittance of foreign earnings or capital. Hence, the initial problem which appears is the choice between the use of what might be described as a commodity as opposed to a financial rate. Having developed a solution to this problem there may remain the problem of which of several concurrently existing commodity rates to employ.

Presumably the choice between the use of a commodity or financial rate would be governed by the decision as to which would produce the most rational and meaningful figures for purposes of expressing the dollar value of foreign net assets. Considering this objective, it is possible to develop a case in favor of the use of either of the two rates. It is tempting to conclude that since the principal activity of a foreign subsidiary is concerned with the manufacture or sale of one general type of commodity the use of the selling rate (if both buying and selling rates exist) applicable to that class of commodity represents the most satisfactory basis for translating foreign currency net assets into dollars. On the other hand, it is desirable to consider the fundamental attribute of value of asset holdings. It seems unavoidable to conclude that the value of an asset element (or the negative value of a debt) is represented by the present value of the future cash receipts which the asset is capable of producing. If we apply this concept to the problem at hand, it follows that the most satisfactory measure of the dollar value of foreign currency net assets should be the present value of the future dollar receipts produced thereby. Quite apparently, it is impossible to apply such a rigorous theoretical concept in a practical situation. However, this valuation concept would seem to lead to the use of a rate of exchange which was related to the flow of dollar receipts from the foreign subsidiary. In turn, this reasoning would suggest the use of a financial rate as being productive of the most rational results in terms of the dollar value of foreign net assets. On balance, the second

argument presented above appears the stronger of the two, and for this reason the use of an exchange rate related to the remittance of earnings from the foreign subsidiary for the purpose of translating foreign currency accounts is recommended.

In order to apply the conclusions of the preceding paragraph to an actual situation, we may refer to the tabulation of the various exchange rates currently in effect in Chile, which was presented earlier in this chapter. In the case of a Chilean subsidiary it would seem to be most appropriate to employ the Banking Free Market Rate of 118 pesos per United States dollar for the translation of the accounts of the Chilean subsidiary, since this is the rate which is applicable to the obtaining of dollars for the purpose of remitting profits and dividends of foreign capital.

It is again necessary to consider the question of consistency, this time in relation to the choice of exchange rate for translation purposes. In this situation it is certainly desirable to employ consistently the same rate (commodity versus financial) in the translation process in order to produce results in terms of the dollar value of foreign currency net assets which are comparable. Disclosure of the specific rate which has been employed to produce dollar values is strongly recommended.

Devaluation of Foreign Currency

It will be recalled that in the introductory section of this chapter it was stated that the impact on the reporting of foreign operations of the devaluation of a foreign currency would be considered separately from the other aspects of exchange control. As was stated at that point, this division has been adopted for organizational convenience rather than as a result of the feeling that any fundamental distinction exists between devaluation and the forms of exchange control examined in the immediately preceding section.

Before examining the accounting and reporting impact of devaluation of a foreign currency, it is desirable to describe briefly the meaning of the term and the reasons underlying devaluation as a form of international financial policy. The term devaluation as it is typically employed may be said to describe an abrupt and substantial downward adjustment in the par value of a particular currency in terms of other currencies. The adjustment results from action on the part of the appropriate governmental authority and not from free market forces. The most recent and historically one of the most widespread devaluation movements occurred during September, 1949. An indication of the extent of the adjustment in the dollar value of the currencies of some of the countries which participated in this wave of devaluation may be gained from the following tabulation showing the dollar value (par) of these currencies before and after the devaluation:[11]

Country	Currency	U. S. Cents per Currency Unit	
		New Rate	Old Rate
United Kingdom	Pound	280	403
Australia	Pound	224	322.4
Belgium	Franc	2	2.2817
Canada	Dollar	90.909	100
Denmark	Krone	14.4778	20.8376
Egypt	Pound	287.156	413.3
Iceland	Króna	10.7054	15.4111
India	Rupee	21	30.225
Iraq	Dinar	280	403
Luxembourg	Franc	2	2.2817
Netherlands	Guilder	26.3158	37.6953
Norway	Krone	14	20.15
Union of South Africa	Pound	280	403

The motives underlying the depreciation of a currency in terms of foreign currencies may be many and varied. It is obviously impossible in a discussion of this type to examine every facet of the subject exhaustively,

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[11] International Monetary Fund, International Financial News Survey, Vol. II, No. 12.

but it is desirable to summarize briefly the most important objectives of such action. Probably the most common purpose of devaluation, and certainly the one which was primarily responsible for the 1949 devaluation movement, is the correction of a condition of imbalance in the international payments position of the devaluing country. Thus, if a particular country was experiencing a continuing excess of international payments over international receipts, a reduction in the value of its currency in terms of other currencies would, ignoring retaliatory action by other countries, tend to correct this unfavorable balance of payments by increasing exports and decreasing imports of the devaluing country. This result would emerge because the exports of the devaluing country would now be cheaper in terms of foreign currency units and imports from other countries would be correspondingly dearer in terms of the domestic currency. It will be noted that both of these changes have the effect of increasing the demand for domestically produced goods and hence devaluation may be employed as a part of a program to increase employment and economic activity domestically. Quite apparently devaluation may be undertaken in a particular country merely to offset the effect on the demand for the export products of that country of a previous devaluation in another country. Superficial consideration of the problem would lead to the conclusion that devaluation represents a relatively easy way for a particular country to correct an unfavorable balance of payments situation. This conclusion is not supported by a more careful analysis of the effects of devaluation, however. It should be noted that the additional export demand enjoyed by the devaluing country will generally not represent an increase in aggregate demand, but will only be at the expense of other countries. Also the reduced demand for import goods by the devaluing country will cause a reduction in exports of other countries. It follows that the countries which have suffered from the demand shifts in favor

of the devaluing country will take retaliatory action by adjusting the external value of their currency appropriately. If such retaliatory action is general the international payments situation will be the same as it was before the devaluation process was begun. It is difficult, in fact impossible, to determine in advance the precise degree of devaluation which will be necessary to produce the desired effect on the international payments position of the devaluing country. As a result the degree of devaluation is commonly excessive, which of course merely accentuates the speed and magnitude of retaliatory action by other countries. It should be emphasized that if devaluation is contemplated it must, if it is to be at all successful, be accomplished in one instantaneous adjustment, rather than by a series of smaller reductions. Any feeling that a particular downward adjustment in currency value is tentative and that further reductions will occur in the future will cause the postponement of any increase in the foreign demand for the products of the devaluing country. An additional danger related to a downward adjustment in the external value of a currency is the possible effect on the attitude of the citizens of the country making such an adjustment toward the internal value of the monetary unit, with the result that internal inflationary pressures may emerge or be intensified which may wholly or partially negate the favorable effect of the decrease in the external value of the currency. It seems inevitable to conclude that the only satisfactory long-run solution to an unfavorable balance of payments situation is the intensification of efforts to increase productivity with the related decrease in costs making the products of a particular country more competitive in the international market. An increase in the demand for exports resulting from this type of change is not subject to the effect of purely competitive currency value adjustments, as is that resulting from devaluation.

Impact of Devaluation on the Reporting of Foreign Operations

Consideration of the effect of the devaluation of a foreign currency on the problems related to the reporting of foreign operations will be divided into the following areas:

(1) Effect upon the desirability of translating foreign currency balances.

(2) Effect upon the translation of specific balance sheet and operating accounts.

(3) Measurement and method of recognition of the loss caused by devaluation.

Effect Upon the Desirability of Translating Foreign Currency Balances

The only situation in which devaluation of a foreign currency should be so serious a problem as to make any attempt to translate the accounts of a foreign subsidiary into dollars undesirable would be a case in which a particular country had experienced such a number of substantial devaluations over a relatively short period of time as to cast serious doubt on the reliability of the present exchange rates as a continuing measure of the value in dollars of the foreign currency. For example, Italy experienced three major devaluations between June, 1943 and August, 1948. Under such circumstances there may be good reason to consider that the international financial position of such a country is so precarious as to render the expression of lire accounts in dollars (at present exchange rates) meaningless or even misleading. This conclusion might justifiably be reinforced if, as would likely be the case, the devaluation history was coupled with severe restrictions on the convertibility of the particular foreign currency. Such a history of devaluation is not typical among the major commercial countries with which we are principally interested in relation to the problem at hand, however, and the efforts of the International Monetary Fund in the devaluation area should materially reduce cases of recurring devaluation among member countries in the future.

Effect Upon the Translation of Specific Balance Sheet and Operating Accounts

Before considering the impact of devaluation on the process of translating foreign currency account balances into dollars, it is desirable to review briefly the conclusions of Chapters I and II relative to the technique of translating foreign currency balances. In those chapters it was concluded that asset and liability elements the value of which was measured by a fixed number of foreign currency units should be expressed in dollars in terms of the rate of exchange in effect on the date of the translation, and that assets and liabilities the value of which is not measurable in terms of a specific number of foreign currency units should be translated by the application of the rate of exchange in effect when such assets or liabilities were acquired or incurred. Revenue or expense elements should be translated by application of the exchange rate in effect when the revenue or expense is earned or incurred. It is now necessary to examine the effect upon these procedures of the devaluation of a foreign currency.

In order to reach a satisfactory conclusion as to the effect of devaluation on the translation process, it is necessary to consider the real nature of the process in terms of its effect on the dollar value of foreign currency assets and liabilities. It seems reasonable to conclude that the effect of the devaluation of a foreign currency on dollar values is fundamentally the same as though a new foreign currency unit had been adopted, the value of which differed in terms of dollars from the previous currency unit. In fact, the effect might be compared to a strictly domestic situation in which by executive decree the significance of the dollar was materially altered with a resulting restatement of the amount of new "dollars" relating to all legally established rights and obligations. Given either of the preceding points of view, it is only logical to conclude that it is reasonable to give complete recognition to the new monetary unit in accounting

records, and to eliminate therefrom any amounts expressed in terms of the previous unit, which would then be of only historical interest. It follows that the effect of the devaluation of a foreign currency upon the translation of foreign currency account balances into dollars should be to require adoption of the new post-devaluation rate for the purpose of translating all foreign currency assets and liabilities into dollars and to employ pre-devaluation rates only for the purpose of translating current period revenues and expenses which were earned or incurred previous to the effective date of the devaluation.

Turning to more specific applications of the general principles set forth in the preceding paragraph, it is apparent that the existence of a devaluation action would create no problem in relation to the translation of money-value assets and liabilities. The application of the current rate of exchange would obviously mean the use of the post-devaluation rate. It is only in connection with those asset and liability items of a non-money-value nature which are translated by use of the acquisition or incurrence date rate that a problem as to the use of the pre- or post-devaluation rate arises. In general, this category would include fixed assets, long-term debt, and contributed capital accounts. The position of the American Institute of Accountants in regard to translation of these items in a non-devaluation situation was presented in Chapter I. It is now appropriate to review the effect of devaluation on the recommendations of this organization. Its position is stated as follows:

Fixed Assets

> Generally, the rule for translation of fixed assets at rates in effect when the asset was acquired or constructed should be followed. One exception to this rule might be with respect to current plant additions when income is translated at post-devaluation rates. Another exception might be with respect to fixed assets acquired with foreign capital, to which reference is made later. When, however, fixed assets are purchased with United States dollars, or when they are purchased in foreign currencies presumably out of profits which are not restricted

as to withdrawal, the United States dollar cost or the dollar equivalent of the foreign currency at the date of purchase should be recognized as the amount at which such assets should be carried.

Long-term Liabilities

Translation of long-term liabilities presents possibly the greatest deviation from the principles previously stated by the committee. The committee generally has favored translating long-term liabilities at the rates of exchange prevailing when the liability was actually contracted, but recognized that there were exceptions. The purpose was to avoid giving recognition to minor fluctuations in foreign currencies. The argument has been advanced, however, and apparently without satisfactory rebuttal, that long-term bonds will be paid off in post-devaluation currencies and therefore should be translated at post-devaluation rates. The argument may not be compelling in any given instance, but the logic supporting it is convincing for a fall in rates of the breadth and size of the one just witnessed. Accordingly, with respect to long-term bonds, the general rule should be modified to permit translation at post-devaluation rates.

Under certain circumstances, the gain resulting from restating the long-term debt at the lower rates of exchange may appropriately be off set against the loss arising from translation of net current assets. However, when fixed assets held in the foreign country were acquired with funds obtained in that country, it may be appropriate to restate the fixed assets to the extent of the reduction of the related debt.

Capital Stock

Consideration also should be given to the rates at which capital stock stated in foreign currencies are to be translated; whether they should be translated at historical rates, or at the average of rates applicable to the net assets, or at the post-devaluation rates, would depend on the circumstances in the individual cases.[12]

It will be noted that the preceding statement represents, by and large, a recommendation that previously advocated procedures for the translation of the asset, liability, and net worth items in question be continued, with the rather reluctant admission that, under certain special circumstances, modification of traditional techniques may be permitted. It is impossible to escape the conclusion that the above recommendations represent an attempt to offer more latitude to the accounting profession in dealing with the problems created by the devaluation of foreign currencies, rather than the

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[12] American Institute of Accountants - Research Department, op. cit., pp. 6-7.

results of an attempt to analyze the effect of devaluation on the more fundamental aspects of the determination of the dollar value of foreign assets, liabilities, and the resulting stockholder equity.

For example, if we consider the problem of determining the dollar value of foreign fixed assets, it seems essential to consider the fundamental attributes of value as applied to long-lived assets. By and large, it is the ability of an item of plant or equipment to create a stream of future cash inflows as a result of its employment in a particular business enterprise which justifies the assignment of value to such item. Because of the inability, in an actual situation, to determine with any sort of precision the magnitude and incidence of future cash receipts which may be identified with a particular fixed asset item, it is traditional to resort to the original outlay to acquire the item as the best measure of the value at the time of acquisition and to assume that this original value gradually expires in some sort of relation to the passage of time and intensity of use of the particular asset. The impact of devaluation of a foreign currency on the dollar value of foreign fixed assets is readily apparent. The magnitude of the aggregate stream of <u>dollar</u> cash receipts produced by the operations of the subsidiary will be reduced as a result of the decreased dollar value of the foreign currency and hence it is necessary to conclude that the portion of future dollar receipts attributable to foreign fixed assets has correspondingly diminished. While it is impossible, as previously mentioned, to measure with any sort of precision the amount of the future cash inflows created by fixed asset items and hence to determine the extent of the decrease resulting from devaluation in this amount, it would seem to be appropriate to presume that the decrease resulting from devaluation would bear some approximate relation to the degree of devaluation. From this premise it is necessary to conclude that the dollar value of foreign plant

should be reduced from the equivalent original dollar cost to a new dollar value which at least gives approximate recognition to the probable diminution in future dollar cash inflows attributable to the foreign subsidiary. Translation of the original currency cost at the immediate post-devaluation exchange rate represents a satisfactory procedure for giving recognition to the altered dollar value of the foreign plant assets. There certainly would seem to be no compelling reason to accord distinctive treatment to foreign fixed assets which were acquired shortly before the devaluation action or to plant asset items which were acquired with funds obtained from foreign currency borrowing, as is suggested in the recommendations of the American Institute of Accountants reproduced above. The time of acquisition has no effect on the measurement of value of fixed asset items as outlined above, and there would certainly seem to be no reason to promulgate recommended procedures for the valuation of assets based upon the method employed for valuing a related liability.

Before leaving the problem of the impact of devaluation on the translation of foreign fixed asset accounts, it is desirable to consider a possible alternative point of view, the implementation of which will produce substantially different results from those suggested in the preceding discussion. The examination of this point of view requires consideration of the reason for the devaluation action. It is quite possible the price inflation in the devaluing country has caused the prices of export products of that country, in terms of the currency of other countries, to be so high as to render these products non-competitive in international markets. The devaluation action has the effect of reducing the international price of export commodities, placing the devaluing country in an improved competitive position. In these circumstances, a case may be made for giving recognition to the effect of inflation on the foreign currency values of fixed assets.

This would require an upward adjustment of the recorded amounts for plant assets on the records of the foreign affiliate or at least as a part of the expression of the foreign currency accounts in dollars. If this is done and if the increase in fixed asset values is proportionate to the degree of devaluation, the application of post-devaluation exchange rates to the revised fixed asset amounts will produce at least approximately the same dollar amounts for foreign fixed assets as existed before the devaluation. This technique will, of course, introduce a new stockholders' equity element in the nature of appraisal surplus into the accounts of the foreign subsidiary or at least into the translated dollar accounts.

If the devaluation was motivated by the existence of domestic price inflation in the devaluing country, this procedure would appear to be sound in relation to the valuation criteria presented above. Under these circumstances the higher foreign price level would cause a larger stream of foreign currency cash inflows attributable to fixed assets. The translation of these amounts into dollars at the post-devaluation exchange rate would tend to result in the maintenance of the pre-devaluation stream of dollar cash receipts emerging from the foreign affiliate.

This point of view has been presented in a secondary position and has not been employed in the illustration of the effect of devaluation presented at a later point in the present chapter for several reasons. In the first place, price inflation is certainly not the only possible motive for devaluation. Foreign prices may be out of line internationally because of inefficient production techniques. This situation, particularly during a post-war reconstruction period, may commonly be caused by failure to keep pace with technological improvements in industrial plant and equipment. Under these circumstances upward adjustments in the carrying value of plant assets would appear to be in direct contradiction of the facts of the situation. Even if price inflation has occurred and in turn represents the

principal reason for devaluation, the problem of increases in the price of specific items as compared with movements of the "general" price level remains. Should plant assets be revalued upward in terms of the change in the general price level or in terms of the increase in the price of specific plant assets? This is a problem which has caused considerable difference of opinion in regard to dealing with the effect of price level changes in a purely domestic situation. In addition, there is no reason to believe that the adjustment in the external value of the currency caused by the devaluation will bear a close relationship to the degree of internal price inflation, particularly to the movement of specific prices of fixed asset items. For these reasons, the procedure previously presented is felt to represent the most satisfactory technique of dealing with the effect of devaluation on the translation of foreign currency plant assets. It should be recognized, however, that circumstances may exist in which restatement of the original foreign currency cost of plant assets is appropriate. This procedure, coupled with translation of the revised fixed asset account balances at post-devaluation exchange rates, may produce approximately the same results which would emerge from the translation of the original foreign currency cost at the acquisition (pre-devaluation) exchange rate. The danger that this similarity of result may create the impression that this procedure is what is being suggested without examination of the underlying circumstances represents another reason for suggesting downward restatement of the dollar value of foreign fixed assets as being the preferable procedure.

The logic supporting the somewhat reluctant admission of the American Institute that "....with respect to long-term bonds, the general rule should be modified to permit translation at post-devaluation rates," is much more acceptable than in the case of fixed assets. However, in view of the obvious change in the dollar value of foreign currency debt accompanying a change in

the dollar value of the foreign currency, it would seem that the word "permit" in the preceding quotation should be changed to "require". It is difficult, if not impossible, to attach any significance in relation to the measurement of financial position to the dollar magnitude of foreign debt when this dollar magnitude was produced by applying pre-devaluation exchange rates.

It will be recalled that the American Institute carefully avoids making any sort of positive recommendation in connection with the translation of the capital stock of a foreign subsidiary. It would certainly seem that careful consideration of the fundamental effect of devaluation on the dollar value of the net assets of a foreign subsidiary would permit the development of at least somewhat more specific suggestions than are contained in the quotation presented above relating to the translation of capital stock. If the conclusions contained in the preceding discussion of the impact of devaluation on the dollar value of foreign fixed assets is accepted, it is logically necessary to agree to similar conclusions regarding the dollar value of the foreign subsidiary as a business enterprise. It then follows that the act of devaluation requires recognition, in measuring the total dollar value of the foreign subsidiary, of a decrease which in amount may be considered as being proportionate to the extent of the reduction in the dollar value of the foreign currency. This means that the stockholder equity is decreased in an amount measured by the decline in the dollar value of the foreign net assets. The problem remains of assigning this decrease to the specific components of the stockholder equity of the foreign subsidiary, e.g., contributed capital as opposed to retained earnings. It would seem that two alternatives are available for reporting purposes. On the one hand, the contributed capital element may be stated in dollars at its equivalent original dollar amount (translated at pre-devaluation rates) and the entire decrease in dollar net asset value absorbed in the retained earnings

account. As an alternative to this procedure the contributed capital element or elements may be reduced in terms of their dollar value by translation at the post-devaluation rate and the remainder of the shrinkage in dollar value of net assets absorbed in the retained earnings element. The choice between these two alternatives is not easily made on completely logical, analytical grounds. In fact, this particular situation emphasizes the possible desirability, even in strictly domestic situations, of ignoring the "slicing" of corporate net worth and thinking instead of a single amount as representing the total stockholder equity. If this point of view were adopted, there would be no allocation problem since the total decrease in dollar net asset value of the foreign subsidiary would be applied as a reduction in the total stockholder equity. However, in order to give recognition to presently employed reporting procedures it is necessary to retain the legal point of view regarding the distinction between invested capital and retained earnings, and hence to take a position regarding the assignment within the foreign subsidiary's net worth accounts of the devaluation "loss". Since the position has been adopted in this discussion that the act of devaluation in fact involved the adoption of a new currency unit by the foreign country, at least in terms of other countries, it would seem to be consistent to suggest that the subsidiary's invested capital categories should be revalued to give recognition to this change by translating such accounts at the post-devaluation rate of exchange. The effect of using each of these alternatives will be presented in the illustration of devaluation set forth later in this chapter.

Turning to the effect of devaluation on the translation of revenue and expense accounts it is again appropriate to examine the recommendations of the American Institute of Accountants, as reflected in the following statement:

Operations

In many cases it may be desirable to follow the recommendations of Bulletin No. 4, which would result in the application of both pre- and post-devaluation rates to the operations of a single year. There may, however, be situations in which more realistic results would be obtained if income computed in foreign currencies were to be translated for the entire fiscal year at the post-devaluation rates. This procedure would have the practical advantage of making it unnecessary to cut off at the date of the devaluation. Where dividends have been paid prior to the devaluation date, out of earnings of the current fiscal year, that portion of the income for the year should be considered as having been earned at the pre-devaluation rate irrespective of the rate that may be used in translating the remainder of the earnings accumulated prior to the devaluation date.

There may be cases in which the income statement would present very misleading results if the pre-devaluation exchange rates were used for a large part of the fiscal year, and the loss resulting from the fall in exchange rates were charged to retained income (surplus). Obviously, the charge to income for the fall in exchange should not be less than the loss applicable to the increase in net current assets since the beginning of the fiscal year during which devaluation took place.[13]

Once again it appears as though the principal objective of the preceding statement was to sanction any of a wide variety of techniques of translating operating accounts for a period during which devaluation of the foreign currency took place, rather than an attempt to develop logical procedures based on the objectives of the translation process. There would seem to be no valid reason for modifying the conclusions of Chapters II and III regarding the translation of revenue and expense accounts. At that point it was concluded that the objective of the translation of foreign currency revenue and expense items should be to produce dollar amounts which represent the dollar equivalent of the foreign currency balances. The only way in which this result can be produced with reasonable accuracy is to apply month-end rates to monthly revenue and expense amounts. This becomes particularly valid when a substantial alteration in the dollar value of the foreign

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[13] Ibid, p. 6.

currency has occurred during an operating period. Under these circumstances, the use of an average of exchange rates in effect during the operating period becomes particularly unreliable unless the average is weighted with extreme care to give proper effect to the pre- and post-devaluation level of exchange rates. In the preceding quotation it was stated that the use of post-devaluation rates for the purpose of translating revenues and expenses has the practical advantage of eliminating the necessity for a cut-off as of the date of the devaluation. While this statement is certainly technically valid, it hardly seems proper to adopt an unsatisfactory procedure (in terms of the results produced) entirely on the grounds of practical expediency. The effect of using post-devaluation rates for the purpose of translating foreign currency revenues and expenses for an operating period during which a substantial alteration in the dollar value of the foreign currency occurred has the same effect on the accuracy of the measurement of the exchange (in this case devaluation) loss or gain as does the use of the closing exchange rate for the translation of operating accounts for a period during which devaluation was not a problem. It will be recalled from the illustrations presented in Chapter III that, in essence, the result of translating revenues and expenses at the closing rate is to merge the gain or loss from exchange rate fluctuations with the gain or loss from merchandising or manufacturing activities. It is difficult to visualize how the necessity for determining the foreign currency revenues and expenses by months presents a particularly difficult problem. The determination of inventory amounts and hence cost of goods sold would very likely present the greatest difficulty. In the event perpetual inventory records were not maintained, the calculation of an estimated value of inventories and the related measurement of cost of goods sold prior to the date of the devaluation by use of the gross profits method would represent a satisfactory approximation. Substantial devaluation of a

foreign currency will certainly not be a frequently recurring problem and it would appear that the additional effort involved in satisfactorily dealing with the impact of this significant event on the reporting of foreign operations represents a very appropriate activity. In summary, the devaluation of a foreign currency should have no effect on the procedures for the translation of foreign currency revenues and expenses which were developed in Chapters II and III. The application of month-end rates to the foreign currency amounts for each month of the fiscal period still represents the most satisfactory procedure. In the event that the devaluation occurred within a month it will be satisfactory for the purpose of translating operating accounts to assume that the substantial change in exchange rates occurred at the end of that particular month. This procedure will be demonstrated in the illustration presented later in the present chapter.

Measurement of the Loss Caused by Devaluation

The loss occasioned by devaluation of a foreign currency is only a special case of the general area of exchange rate gains or losses described in Chapter III. The computation of the amount of the devaluation loss may be accomplished by employing the same techniques which were developed at that point with one important exception. It will be recalled from the discussion in Chapter III that the gain or loss from market exchange rate movements was measured by the alteration in the dollar value of foreign currency net-money-value assets caused by changes in the dollar value of the foreign currency. When we turn to the calculation of the magnitude of the loss occasioned by devaluation, it is necessary to go beyond the change in the dollar value of net-money-value assets and to include non-money-value foreign assets as well. This is the result of the recommendations contained in the preceding section of the present chapter that a substantial devaluation of a foreign currency actually represents the adoption of a new currency

unit by the devaluing foreign country and that the application of sound concepts of asset valuation require modification of the dollar value of foreign currency non-money-value assets to reflect the fundamental alteration in the foreign currency unit. The conclusion then emerges that the loss caused by devaluation should be measured by the decline in the dollar value of the total foreign currency net assets as of the date of the devaluation. Since the effective date of the devaluation action will typically not be the end of a calendar month, practical expediency may require the adoption of the assumption, which was mentioned in the preceding paragraph relative to the translation of revenue and expense accounts, that the devaluation occurred as of the end of the month during which it was actually effective. The computation of the devaluation loss in an illustrative situation will be described in a succeeding section of this chapter.

Disposition of the Devaluation Loss in the Accounts of the Domestic Parent Corporation

Having dealt with the problem of calculating the loss caused by devaluation of a foreign currency, it is now appropriate to consider the treatment which should be accorded this loss in the accounts of the domestic parent corporation. Obviously, this problem will only exist when the parent corporation gives recognition to undistributed subsidiary profits or to losses, whether by including the accounts of the foreign subsidiary in consolidated financial statements or by adjusting the investment account to give recognition to changes in subsidiary net assets. If the parent corporation carries its investment in the foreign subsidiary at cost (or less) and records subsidiary earnings only when dividend remittances are received, the problem of recognition of the devaluation loss will not require any particular consideration. Under these circumstances the devaluation loss will influence the parent corporation's accounts, if at all, only in the form of the reduced number of dollars received as dividends from the

foreign subsidiary.

In general, the same possibilities as to alternative treatment of the devaluation loss in the accounts of the parent corporation exist as in the case of the gain or loss resulting from day-to-day exchange rate adjustments. If we exclude the possibility of according some sort of reserve treatment to the devaluation loss, the problem resolves itself into the choice between including the devaluation loss in the computation of net income for the fiscal period during which the devaluation occurred or absorbing the loss directly in the stockholder equity, presumably in the retained earnings account. It will be recalled that in Chapter III it was concluded that the most satisfactory treatment to be accorded to exchange gains or losses caused by market variations in exchange rates was to include such gains or losses in the computation of net income, with statement presentation below the net operating income "line" if desired. At that point it was recognized that the problem of dealing with the loss occasioned by devaluation of a foreign currency differed, both in terms of recurrence and materiality, from that of dealing with so-called "normal" exchange gains or losses. This difference is indicated by the following statement relating to the treatment of the devaluation loss:

> .....it should be noted that the committee on accounting procedure in Accounting Research Bulletin No. 32 emphasized that only when charges of the type described therein are material in the aggregate in relation to the company's net income, do they upset the general presumption that all items of profit and loss should be used in determining net income. While the possibility of losses from currency devaluation may ordinarily be considered to be a risk inherent in the conduct of business in foreign countries, the worldwide scope and unprecedented magnitude of the recent devaluations of foreign currencies are such that they cannot be considered recurrent hazards of business. Accordingly, the losses resulting from such devaluation would appear to be of such a nature that, if they are so material in amount that their inclusion in the income statement would impair the significance of net income to an extent that misleading inferences might be drawn therefrom, they might appropriately be charged to retained income (surplus) under the provisions of Bulletin No. 32.[14]

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[14] Ibid, p. 5.

The position set forth in the preceding statement would appear to represent a satisfactory guide to the problem of assigning the charge resulting from the reduction in dollar value of foreign currency net assets caused by the devaluation of the foreign currency, although it admittedly leaves something to be desired in terms of providing any criteria to assist in the determination of materiality in relation to net income. The possibility of eliminating the devaluation loss from the income statement will be strongly objected to by proponents of the "all-inclusive" or "historical" concept of the income statement. However, as has been previously mentioned, it is not appropriate in this discussion to examine the merits of the various concepts of the nature of the income statement. Rather, it will be considered acceptable reporting practice to include the devaluation loss in the calculation of net income or to treat it as a charge directly to retained earnings, whichever it is felt will produce the most informative financial statements (particularly income statement) in the particular situation. Adequate disclosure of the magnitude and cause of the loss should be considered to be essential to adequate reporting, regardless of the specific disposition statementwise of the loss.

Illustration of the Impact of Devaluation on the Translation of Foreign Currency Accounts

The discussion of the effect of devaluation of a foreign currency will be concluded by the presentation of an illustration of the problems of translating the accounts of a foreign subsidiary for a fiscal period during which devaluation occurred.

As a basis for illustrating the effect of devaluation on the translation process, assume the following foreign currency trial balance on December 31, 1952:

A FOREIGN SUBSIDIARY
Trial Balance
December 31, 1952

Cash	20,000	
Accounts receivable	40,000	
Merchandise inventory	100,000	
Fixed assets	240,000	
Allowance for depreciation		48,000
Accounts payable		72,000
Long-term note payable		100,000
Capital stock		150,000
Retained earnings		30,000
	400,000	400,000

Assume further that the applicable exchange rate on December 31, 1952, was four foreign currency units to one dollar and that the rate when the capital stock was issued and the fixed assets acquired was three foreign currency units to one dollar. The December 31, 1952 trial balance, expressed in dollars, would appear as follows:

A FOREIGN SUBSIDIARY
Trial Balance (in dollars)
December 31, 1952

Cash	5,000	
Accounts receivable	10,000	
Merchandise inventory	25,000	
Fixed assets	80,000	
Allowance for depreciation		16,000
Accounts payable		18,000
Long-term note payable		25,000
Capital stock		50,000
Retained earnings		11,000
	120,000	120,000

The preceding dollar trial balance results from the translation of current assets, current liabilities, and the long-term note payable at the December 31, 1952 exchange rate of four to one, the fixed assets, related allowance for depreciation, and capital stock at the acquisition or issuance rate of three to one, and the retained earnings at the dollar amount necessary to equate total assets and total equities. This involves assuming that the merchandise inventory was acquired while the exchange rate was four to

one, since inventories are not in the same category as other current asset items in relation to the applicability of the current rate of exchange. It should also be noted that, if more information had been presented, the retained earnings would not have been translated as a "plug", but rather would have been determined by applying the dollar earnings for 1952, the exchange gain or loss for 1952, and the dollar equivalent of any dividends paid during 1952 to the December 31, 1951 balance of retained earnings, expressed in dollars.

The following tabulation summarizes the transactions of the foreign subsidiary for the year ended December 31, 1953:

	January 1, 1953 to June 30, 1953	July 1, 1953 to December 31, 1953	Total
(1) Sales	600,000	800,000	1,400,000
(2) Collections on accounts receivable	580,000	700,000	1,280,000
(3) Purchases of merchandise	480,000	600,000	1,080,000
(4) Payments on accounts payable	520,000	580,000	1,100,000
(5) Expenses paid	60,000	72,000	132,000
(6) Paid on long-term note payable	10,000	10,000	20,000
(7) Merchandise inventory, December 31, 1953			130,000
(8) Depreciation of fixed assets			10% per annum

In order to focus attention on the effect of devaluation of the foreign currency on the process of translating the foreign currency account balances, it will be assumed that the exchange rate remained at four to one from January 1, 1953 to June 30, 1953, on which date by appropriate governmental action the rate of exchange was altered to eight to one, which rate remained effective during the remainder of 1953. The problems which would be created by small month-to-month changes in the rate of exchange would be solved in precisely the same manner which has already been illustrated in

Chapter III and inclusion of such changes in this illustration would only serve to submerge the principal issue, namely the effect of the June 30, 1953 devaluation. The working papers presented on the following pages set forth the derivation of the December 31, 1953 foreign currency trial balance, the translation of this trial balance into dollars, and the separation of the resulting dollar trial balance as between income statement and balance sheet accounts. The entries in the transactions column are identified with the same numbers employed in the preceding tabulation setting forth the transactions.

	Foreign Currency Units					
	Trial Balance December 31, 1952		1953 Transactions Dr.	1953 Transactions Cr.	Trial Balance December 31, 1953	
Cash	20,000		1,280,000(2)	1,100,000(4) 132,000(5) 20,000(6)	48,000	
Accounts receivable	40,000		1,400,000(1)	1,280,000(2)	160,000	
Merchandise inventory	100,000		1,080,000(3)	1,050,000(7)	130,000	
Fixed assets	240,000				240,000	
Allowance for depr.		48,000		24,000(8)		72,000
Accounts payable		72,000	1,100,000(4)	1,080,000(3)		52,000
Long-term note payable		100,000	20,000(6)			80,000
Capital stock		150,000				150,000
Retained earnings		30,000				30,000
	400,000	400,000				
Sales				1,400,000(1)		1,400,000
Expenses			132,000(5)		132,000	
Cost of sales			1,050,000(7)		1,050,000	
Depreciation			24,000(8)		24,000	
					1,784,000	1,784,000

	Foreign Currency Trial Balance December 31, 1953		Translation Rate	DOLLARS Trial Balance		Income Statement		Balance Sheet	
Cash	48,000		8	6,000				6,000	
Accounts receivable	160,000		8	20,000				20,000	
Merchandise inventory	130,000		8	16,250				16,250	
Fixed assets	240,000		8	30,000				30,000	
Allowance for depreciation		72,000	8		9,000				9,000
Accounts payable		52,000	8		6,500				6,500
Long-term note payable		80,000	8		10,000				10,000
Capital stock		150,000	8		18,750				18,750
Retained earnings		30,000	December 31, 1952 balance		11,000				11,000
Sales		1,400,000	600,000 @ 4						
			800,000 @ 8		250,000		250,000		
Expenses	132,000		60,000 @ 4						
			72,000 @ 8	24,000		24,000			
Cost of sales	1,050,000		450,000 @ 4						
			600,000 @ 8	187,500		187,500			
Depreciation	24,000		12,000 @ 3						
			12,000 @ 8	5,500		5,500			
	1,784,000	1,784,000				217,000	250,000		
Exchange loss				16,000		16,000			
				305,250	305,250				
Net income						17,000			17,000
						250,000	250,000	72,250	72,250

Several comments relative to the working paper presented on the preceding page are in order. It will be noted that all balance sheet accounts, other than retained earnings, have been translated at the post-devaluation rate of eight to one. This procedure is in accordance with the recommendations of the preceding section of this chapter. The revenue and expense account balances have been divided into two segments for translation purposes. The revenue earned (sales) and expenses incurred during the first half of 1953, prior to the devaluation, have been translated at pre-devaluation rates. The amounts relating to the last half of 1953 have been expressed in dollars by applying the post-devaluation rate of eight to one. In this connection it is necessary to explain the manner in which cost of sales has been divided between the pre- and post-devaluation period. It will be noted that the cost of sales for the year 1953 (1,050,000 foreign currency units) is seventy five per cent of the sales for the year (1,400,000 foreign currency units). This same per cent has been applied to the sales for the first half of 1953 to arrive at the cost of sales for that period of 450,000 foreign currency units. Obviously, if perpetual inventory records were maintained or if a physical inventory had been taken on June 30, 1953, the amount resulting from one of these sources would have been employed.

It must be recognized that the amount ($16,000) described as exchange loss on the preceding working paper is entirely attributable to the devaluation occurring on June 30, 1953, since there were no other exchange rate movements during 1953. It is even more important to note that this amount does not represent the total loss caused by devaluation of the foreign currency. Since the capital stock account was translated into dollars by applying the post-devaluation exchange rate of eight to one, a substantial part of the exchange loss has been automatically absorbed in this section of the net worth of the foreign subsidiary. The total loss from devaluation

may be calculated as shown in the following tabulation. The balances of asset and liability accounts shown in this tabulation are those which would result from the application of the transactions for the first half of 1953 to the December 31, 1952 account balances.

	Foreign Currency Units	Dollar Value @ pre-devaluation rates	Dollar Value @ post-devaluation rate
Assets:			
Cash	10,000	$ 2,500	$ 1,250
Accounts receivable	60,000	15,000	7,500
Merchandise inventory	130,000	32,500	16,250
Fixed assets - net	180,000	60,000	22,500
Total		$110,000	$47,500
Liabilities:			
Accounts payable	32,000	$ 8,000	$ 4,000
Long-term note payable	90,000	22,500	11,250
Total		$ 30,500	$15,250
Net assets		$ 79,500	$32,250

The loss from devaluation is measured by the decreased dollar value of the June 30, 1953 net assets, as shown below:

Dollar net assets - June 30, 1953:	
At pre-devaluation rates	$79,500
At post-devaluation rate	32,250
Decrease in dollar value of foreign currency net assets caused by devaluation	$47,250

On the working paper presented on page 194, the devaluation loss of $47,250 is reflected in two places in the December 31, 1953 dollar trial balance. $16,000 appears as the amount necessary to balance the dollar trial balance and $31,250 is "buried" in the capital stock account as a result of reducing the dollar value of capital stock from the pre-devaluation amount of $50,000 to the post-devaluation dollar equivalent of $18,750. Because of the procedure employed, the amount of $17,000 described as net income for the year 1953, is not a completely satisfactory measure of the over-all results of the operations of the foreign subsidiary for this period, since

it includes only a part of the loss attributable to the June 30, 1953 devaluation. A more satisfactory working paper measure of the loss from devaluation and the over-all results of operations for 1953 might be produced if the capital stock account was included in the December 31, 1953 dollar trial balance at the pre-devaluation dollar equivalent of $50,000. If this were done the amount of the devaluation loss necessary to balance the December 31, 1953 dollar trial balance would be changed to $47,250, which, as was demonstrated in the preceding tabulation, is the correct amount of the devaluation loss. In addition, this procedure will cause the working paper to reflect an over-all net loss for the year 1953 of $14,250 which is the correct measure of the decrease in the dollar value of the subsidiary net assets during 1953, as set forth in the following tabulation:

Dollar value of subsidiary net assets:	
December 31, 1952	$61,000
December 31, 1953	46,750
Decrease	$14,250

It does not appear to be of fundamental importance how the devaluation loss is assigned as between capital stock and retained earnings of the subsidiary, as long as it is recognized as representing a decrease in the total shareholder equity of the subsidiary corporation. The important consideration is the recognition of the factors contributing to the over-all net loss, as between net income from regular operations of the foreign subsidiary and the devaluation loss. The details of the over-all net loss may be presented as shown in the following income statement:

A FOREIGN SUBSIDIARY
Income Statement (in dollars)
Year Ended December 31, 1953

Sales		$250,000
Less:		
Cost of goods sold	$187,500	
Depreciation	24,000	
Other expenses	5,500	217,000
Net income from operations		$ 33,000
Less devaluation loss		47,250
Net loss		$ 14,250

The same point which was emphasized in Chapter III regarding the desirability of a reasonably precise distinction between income or loss from operations, as compared with gain or loss caused by exchange rate movements requires emphasis again at this point. In fact, in view of the possible magnitude of the loss caused by devaluation, it appears to be particularly important that the amount of such loss be measured with reasonable accuracy in order that managerial review of the efficiency of foreign operations be directed to those aspects of the operations which are of a controllable nature, as opposed to that part of the over-all results emerging from governmental action.

In concluding this illustration, it is desirable to summarize briefly the impact of the translation of the accounts of the foreign subsidiary and the measurement of its operating results on the accounts of the domestic parent corporation. In order to stop short of the problems related to the preparation of consolidated statements, let us assume that the parent company takes up its share of subsidiary earnings in the investment account. It will also be assumed that the parent corporation owns 100% of the outstanding capital stock of the subsidiary, which was acquired on the date the subsidiary corporation was organized. Under these circumstances, the investment account on the records of the parent corporation on December 31, 1952, would show a balance of $61,000 which was the amount of the dollar value of the

subsidiary net assets on that date. The results of the subsidiary operations for the year 1953 would be recorded by either of the entries presented below, depending on whether or not the parent corporation desired to consider the loss caused by devaluation as a direct charge to retained earnings or to include this amount in the current profit or loss of the subsidiary.

Entry if Devaluation Loss is Included in 1953 Operating Results of the Subsidiary

Loss of Subsidiary	14,250	
Investment in Subsidiary		14,250

Entry if Devaluation Loss is Recorded as a Direct Charge to Retained Earnings

Retained Earnings	47,250	
Investment in Subsidiary		14,250
Profit of Subsidiary		33,000

It will be noted that the effect on the investment account is the same in either of the preceding entries, namely to adjust the balance to $46,750, which amount is equal to the dollar value of the subsidiary's net assets on December 31, 1953.

The same alternatives as to treatment of the devaluation loss as opposed to the results of regular operations are available in connection with the preparation of consolidated financial statements.

Summary

The present chapter has been devoted to an examination of the purposes and resulting forms of governmental control of the foreign exchanges and the impact of such controls on the problem of reporting foreign operations. For convenience of organization, the discussion has been divided between restrictions on the convertibility of foreign currencies and the existence of multiple exchange rate practices on the one hand and the devaluation or depreciation of the external value of a foreign currency on the other.

In the first area, it has been concluded that restrictions on the convertibility of a foreign currency into dollars should not per se be considered as rendering the recognition of restricted unremitted foreign earnings inappropriate. In fact, when such restrictions are principally aimed at limiting capital transfers, they should exert no direct influence on the recognition of undistributed foreign earnings. Restrictions on the transmission of funds representing current profits create a more difficult problem, but it has been concluded that, in general, recognition of unremitted foreign earnings under such circumstances represents desirable procedure in relation to methods employed in analogous situations involving domestic subsidiaries.

In situations in which various exchange rates are prescribed for particular foreign receipt and payment transactions, it was concluded that the rate which is effective for the acquisition of dollar exchange for financial remittances represents the most satisfactory rate for translation purposes.

It was concluded that the substantial devaluation of a foreign currency represented, in essence, the adoption of a new currency unit by the devaluing country, which in turn required the revaluation, in terms of dollars, of all foreign assets and liabilities in recognition of the impact of the reduced dollar value of the foreign currency. The loss occasioned by devaluation should be measured by the reduction in dollar value of the net assets of the foreign subsidiary as of the date of the devaluation. In situations in which the parent company gives recognition to undistributed foreign subsidiary earnings in its accounts either by adjusting the investment account or by preparing consolidated financial statements, this loss may be considered as a part of operating results for the period during which the devaluation occurred or it may be treated as a direct reduction in

parent company (or consolidated) retained earnings, dependent upon the magnitude of the loss in relation to parent company (or consolidated) net income.

CHAPTER V

INCLUSION OF THE ACCOUNTS OF FOREIGN SUBSIDIARIES IN CONSOLIDATED FINANCIAL STATEMENTS

One of the major problems relating to the reporting of foreign operations during the last two decades has been the question of the desirability of including the accounts of foreign subsidiary corporations in consolidated statements of the American parent corporation and domestic subsidiary corporations. The present chapter will be devoted to an inquiry into the considerations which bear upon this problem, together with consideration of alternatives to complete consolidation of the accounts of foreign affiliates with those of domestic corporations. Discussion of the familiar technical problems related to the preparation of consolidated financial statements involving American parent and subsidiary corporations will be minimized in order to focus attention on the special problems related to the foreign subsidiary case.

Nature and Significance of Consolidated Financial Statements

Before turning to the particular problems related to the inclusion in consolidated statements of the accounts of foreign subsidiary corporations, it is desirable to explore briefly the fundamental nature of consolidated financial statements and the significance of the information contained in such statements to various interested groups. The following statement summarizes the nature of consolidated financial statements in relation to the objectives underlying their preparation:

> The essential purpose of consolidated statements, as just suggested, is to display the financial position and earning power of two or more associated enterprises as a single undertaking. Consolidated statements disregard legal lines of cleavage and emphasize financial and managerial unity. In such reports intercompany accounts and relationships are eliminated and a picture is drawn of the aggregate enterprise in its relationship to the external business community.[1]

The implications of the term "associated enterprises" as used in the preceding quotation will be discussed in the succeeding section of this chapter.

In essence, the above quotation boils down to the suggestion that consolidated statements are designed to give recognition to the existence of a single "economic" entity regardless of the number of legally separate and distinct business units which may be included therein.

The preceding statement as to the purposes motivating the preparation of consolidated financial statements raises the question of the relationship between consolidated reports and the financial statements of the separate legal units which are included in the consolidated group. There is reasonably general agreement at the present time that consolidated statements, while performing an extremely useful function in situations in which their preparation is appropriate, should not be considered as replacing the financial statements of the constituent corporate entities included in the consolidation. The following statement reflects the typical attitude in this area:

> Consolidated statements should be regarded as a supplement to, rather than a substitute for, unconsolidated statements of the constituent companies. It is perhaps regrettable, therefor, that there is a growing tendency to include in published annual reports of a parent company only the consolidated statements of the parent and its subsidiaries, without unconsolidated statements of the parent and without comprehensive data relative to the affairs of the subsidiaries.[2]

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[1] W. A. Paton, Advanced Accounting (New York: The Macmillan Company, 1949), p. 751.

[2] Finney and Miller, op. cit., p. 523.

The reasons for the prevalent attitude which regards consolidated financial statements as supplementary to individual company statements will become apparent when we consider the significance of the information presented by consolidated statements to those groups which are interested in corporate financial data. It is convenient to undertake this inquiry by considering the value of consolidated financial data to each of the principal groups of individuals or agencies involved.

Turning first to creditors of the various subsidiary corporations, it is apparent that in the general case the consolidated data are not significant. Creditors of a subsidiary corporation must look to the assets of the single corporate debtor against which their claims run, and, in the absence of intercompany debt repayment guarantees, the assets of the consolidated group including assets of the parent corporation and perhaps other subsidiaries, are not available for satisfaction of their claims.

Creditors of the parent or holding company may attach varying degrees of significance to the data contained in consolidated statements. Short-term creditors must look to the presently existing liquid assets of the parent corporation for satisfaction of their claims, and hence cannot draw meaningful conclusions from consolidated totals. Since long-term creditors are concerned with future trends of earnings and the resulting asset structure of the parent company, it is possible that consolidated statements may be of some significance to this group. Even in this situation, however, it must be recognized that any conclusions as to the future trend of earning power and asset structure of the parent corporation which may be drawn from consolidated financial statements must be considered as highly tentative. It should be recognized, however, that bond indentures or other types of long-term loan agreements may include covenants which relate to consolidated net current assets or consolidated earned surplus.

The outside or minority stockholders of a subsidiary corporation cannot justifiably attach any direct significance to the statements of the consolidated group. One prominent authority in the field of consolidated statements presents the following description of the position of minority shareholders in relation to consolidated statements:

> In general, presumably, outside or minority stockholders of subsidiaries will not receive any information of direct benefit to them from consolidated reports. As consolidated groups function the outside shareholders are mere passive participants in the combination. The fate of their investment is almost completely at the mercy of the controlling group. This is not meant in any sense invidious to the group in control but in the simple and obvious sense that in matters of business policy the outside shareholders must accept the decisions of the controlling group. The participation by outsiders may be profitable to them-their anticipations probably run along these lines-but nevertheless they are in no position, legally or economically, to direct the ordinary course of business events impinging on their investments. To these shareholders the statements of immediate direct interest are those of the legal entity whose stocks they own.[3]

It should be noted that the preceding statement again emphasizes the primary character of legal entity statements and the resulting supplementary position of consolidated reports.

There remains only one directly interested group to consider, namely the stockholders of the parent corporation and, acting as their agents, the management of the parent. It seems reasonable to consider these two groups collectively since, presumably, their interests would appear to be substantially the same. It is to this collective group that the information contained in consolidated financial statements is of substantial significance. In a situation in which the preparation of consolidated statements is appropriate, in view of the criteria to be considered in the succeeding section, this is the group which is responsible for, and the beneficiary of the effective control and utilization of, the assets of the consolidated group.

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[3]Maurice Moonitz, The Entity Theory of Consolidated Statements, (American Accounting Association, 1944) p. 14.

It is only logical to conclude that financial data which give recognition to the existence of the consolidated group are vital to the carrying out of this responsibility with maximum effectiveness. This is undoubtedly particularly true in relation to managerial decisions, but would seem also to be valid from the point of view of a long-term investor. It should be recognized, however, that, as was the case in relation to short-term creditors, the consolidated statements are probably of less significance than parent company statements in connection with short-run investment considerations.

Even in connection with parent company management, however, it is vital to recognize that there may be substantial limitations on the usefulness of consolidated data. An example of this situation may be found in the area of parent corporation dividend policy. In the American Car and Foundry case, decided in 1942, the court held that it was not proper for the parent corporation to base its dividend policy on consolidated information. The following statement emphasizes some further shortcomings of consolidated statements which are pertinent to both management and investor interests.

> Mention should be made in particular of the limitations of financial ratios-designed to throw light on immediate and ultimate solvency, operating efficiency, support for particular equities, and other matters-which are drawn from consolidated statements. Combining the data of a very strong current position with those of a very weak position, for example, may result in an average showing not typical of either company and hence likely to be misleading. In general ratios should be computed only in terms of the reports of specific companies, and where it is deemed necessary to apply this line of interpretation to consolidated statements the results should be used with a full knowledge of their limited significance.[4]

The position of regulatory agencies in regard to the significance of consolidated financial statements is largely neutral. The Treasury Depart-

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[4]Paton, op. cit., p. 753.

ment permits the computation of the liability for federal income and excess profits taxes on the basis of consolidated net taxable income, with an addition of two per cent to the tax rate or rates otherwise applicable. The position of the Securities and Exchange Commission is summarized in the following statement:

> The Securities and Exchange Commission has discretionary power to require consolidated statements. Up to the present time, however, the Commission has not issued a general regulation making these statements a required part of registration procedure. In practice, nevertheless, most registrants who are parent companies submit consolidated reports, and the Securities and Exchange Commission's Regulation S-X, Article 4, contains directions as to 'consolidated and combined statements' for those electing to use them.[5]

The various utility regulatory commissions have historically evidenced substantially greater interest in scrutinizing specific inter-company transactions than in the financial data for a group of companies under common control. In relation to the major responsibility of regulatory commissions, namely rate setting, the accounting data of individual operating companies represent the most important financial information.

In summary, it may be said that consolidated statements give recognition to the existence of an area of common control which transcends the legal boundaries of separate corporate entities. These statements should be considered as supplementary to, rather than as a substitute for, the statements of the constituent legal entities. The information presented by consolidated statements is almost exclusively significant to the long-term investors in and the management of the parent corporation, and even in this connection there exists the possibility of inaccurate and misleading conclusions being drawn from consolidated reports. The outside stockholders and creditors of subsidiary corporations, as well as short-term creditors of the parent corporation, are concerned with the financial data of the

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[5]Moonitz, op. cit., p. 9.

specific corporate entity in which they have an equity, consolidated statements being of little significance. Long-term creditors of the parent corporation may gain some insight into future trends relating to the financial status of their debtor, but only of an extremely general nature.

Criteria Bearing upon the Propriety of Preparing Consolidated Statements

In order to attempt to reach a decision as to the desirability, in terms of satisfactory financial reporting, of merging the accounts of foreign subsidiary corporations with those of an American parent corporation and its domestic subsidiaries, it is first necessary to survey the commonly employed criteria which are applied in a situation involving only domestic corporate affiliates. We may then examine the special conditions which relate to foreign subsidiaries and reach a decision as to the impact which these conditions may or should have on the desirability of including foreign subsidiaries in consolidated statements. It must be recognized that variations in the details of specific corporate affiliations make impossible the development of principles or rules which lend themselves to general applicability in an unmodified form. Rather, what may be done is to point out the pertinent factors which must be evaluated in reaching a decision as to the desirability of preparing consolidated statements in a particular case.

It seems reasonable to conclude that there are two fundamental conditions which should be present in order to render the preparation of consolidated statements advisable. These are the existence of common control of the policies and resulting activities of separate corporations for which consolidation is contemplated and a reasonable degree of homogeneity in regard to the type of activities of the affiliated corporations.

Turning to the first of the two fundamental conditions, common control of affiliated corporations, the existence of ownership of a substantial proportion of the voting shares of the subsidiary by the parent immediately comes to mind as the usual medium by means of which control is obtained

and maintained. Thus, in a situation in which a corporation owned all of the outstanding shares of another corporation, with no special conditions existing which impair the right of the parent company to vote such shares, there is little question but what centralization of control over the affairs of the two corporations may ordinarily be presumed to exist to a degree which would justify consolidating their accounts. There may exist, however, a great variety of situations in which ownership of a substantial proportion of the voting shares may not seem to justify consolidation or in which ownership of considerably less than fifty per cent of voting shares may be adequate to place the "minority" corporate shareholder in a position to control the policies and activities of the "subsidiary." It is not appropriate in this inquiry to explore in detail the many diverse situations which serve to complicate the extent of stock ownership as a reliable guide to the existence of centralized control to the degree necessary to justify consolidation. However, the presentation of a few brief examples of such situations is desirable. In the first category, the existence of non-voting stock or bonded debt in a substantial amount may cause a large percentage holding of voting shares to represent such a small part of the total equities of the subsidiary as to render consolidation of the accounts of the subsidiary with those of the parent unrealistic. The existence of voting trusts, nominees, etc., may curtail the controlling influence exercisable by the owner of a majority of voting shares, or may, under particular circumstances, have the opposite effect relative to the holder of less than fifty per cent of outstanding shares. Control may also exist in the real sense with ownership of considerably less than fifty per cent of the total voting shares in situations in which the remaining shares are widely diffused and the owners thereof are indifferent toward exercising their franchise in connection with the election of directors. As an extreme example, control

may exist in the absence of the ownership of any shares in the controlled company. The relationship between Bethlehem Steel Company and Cambria Iron Company is an illustration of this situation. Bethlehem owns none of the stock of Cambria but leases all of its properties under lease running for a term of 999 years. "The accounts of Cambria Iron Company are included in the consolidated statements and schedules....., except that in each case the par value of the outstanding stock of Cambria Iron Company owned by the public is treated as an indebtedness of one of the subsidiaries consolidated and the rental paid under the Cambria Lease is deducted in determining the consolidated net income."[6] All of the above illustrations point up the conclusion that stock ownership as such is not a criterion to be applied in reaching a decision as to the desirability of preparing consolidated statements in a particular case, but rather "...effective control is the decisive factor; stock ownership is merely the instrumentality by means of which control is maintained."[7] This leads in turn to the conclusion that there is no point in attempting to set up any sort of general standard as to what percentage of the stock of an affiliated corporation must be owned in order to justify inclusion of the accounts of that affiliate in consolidated statements. Rather, it is essential to consider all the factors which may come to bear on the question of effective control in a particular case and to reach a conclusion as to the propriety of consolidation after weighing the collective effect of these various factors in terms of the resulting degree of control. It is in connection with "control" that some of the most significant problems which are associated with foreign subsidiaries exist, as will be pointed out at a later point in the present chapter.

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[6] Ibid., p. 26.

[7] Ibid., p. 27.

In the preceding section it was concluded that centralized control over a group of legally distinct corporate entities was a necessary condition to justify the preparation of consolidated financial statements for the group. It appears necessary, however, to go beyond effective control and to insist that this control extend over a group of separate companies which collectively compose an integrated business unit. Only if this is the case can it be said that consolidated financial statements depict the financial position and operating results of an economic entity in the true sense of the term. It should be emphasized that diverse types of activity as between parent and subsidiary corporations is not enough to render consolidation of their accounts inappropriate. The following statement points out the essential considerations which are involved in this connection:

> As an example, assume an automobile company controls a body plant, a glass factory, a steel company, a woodworking corporation, a sawmill, and an installment finance agency. Provided all the constituent units are closely linked in operations, and provided they deal almost exclusively with each other and only incidentally with other enterprises, an integrated area of operations exists and, despite the dissimilarity of functions performed, consolidation appears to be in order. However, if the installment finance agency, for example, has been acquired primarily as an investment, and does a general financing business only a fraction of which is with the customers of the parent or its affiliates, exclusion of that unit from consolidation is proper. A similar conclusion holds for any other constituent unit not an integral part of the combination as an operating entity.[8]

Thus, it should not be the specific nature of the operations of an affiliated company which determines the propriety of including its accounts in consolidated statements, but rather its relation to the other corporate members of the affiliated group or combination, in terms of being a part of an integrated business unit. It is immediately apparent, as was the case with determination of the existence of control, that a decision as to the position of a subsidiary corporation as being within or without the

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[8] Ibid., p. 34.

boundaries of an integrated business unit, and hence as to the appropriateness of consolidation, must be reached after consideration of the facts of each particular case. That there is no unanimity of opinion as to the importance of homogeneity of operations as a criterion related to the preparation of consolidated statements is indicated by the following statement which summarizes the replies received to a questionnaire dealing with this area circulated to practicing accountants. "Although the majority apparently considered homogeneity of operations a basic condition precedent to consolidation, several accountants considered this criterion either unimportant, unsound, or 'greatly overworked'."[9]

It seems clear that in a situation in which effective control of the operating policies of a subsidiary corporation exists and in which the activities of the subsidiary are an integral part of the over-all scope of the operations of the parent company, consolidation of the accounts of the subsidiary with those of the parent company is not only acceptable, but desirable. Many other criteria are commonly set forth in writings in this area, but upon closer examination they all, with one possible exception, are merely subdivisions of or are significant in relation to the determination of the existence of the two basic criteria discussed above.[10] The one possible exception emerges from the application of the principle of consistency to the problem at hand. It is readily apparent that observation of this principle would necessitate the exclusion from consolidation of corporations which are controlled only temporarily or incidentally. Likewise

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[9]American Institute of Accountants - Research Department, "Some Problems Regarding Consolidated and Parent Company Statements," Journal of Accountancy, November, 1953, p. 572.

[10]Geographical location is an example of such a criterion. Only to the extent that the location of a foreign affiliate operates to affect the control exercisable by the domestic parent should this factor enter into the decision as to consolidation.

corporations which are in the process of promotion, liquidation, or reorganization should not be included in consolidated financial statements in the interest of consistent treatment as between years. Actually, the exclusion from consolidated statements in the above mentioned circumstances would likely be required as a result of their not being an integral part of the combined operations of the affiliated group.

Having examined the fundamental criteria governing the propriety of including the accounts of a legally separate corporation in consolidated statements, it is now appropriate to examine the special circumstances relating to the investment in a foreign corporation, insofar as these circumstances may affect the application of these criteria. It is within the area of the existence of effective control that the bulk of the problems created by investment in a foreign subsidiary emerge. It becomes particularly true in the case of a foreign affiliate that ownership of all or a substantial portion of the voting shares does not represent an adequate indication of the existence of effective control. There may exist at least three types of restrictions imposed by a foreign government which operate to limit the degree of control over corporate resources and operations which dominant stock ownership typically conveys. Each of these will be examined and the impact thereof on the effectiveness of control which the parent corporation may exercise will be appraised.

In the first place, it is not uncommon for foreign governments to impose legal regulations requiring a certain per cent of the voting shares of every company incorporated in that country to be held by nationals of the particular country. Quite apparently, this immediately precludes complete ownership of the voting shares of a foreign affiliate and in some cases the required percentage of local ownership may be substantial. No general conclusion may be reached as to the effect of such requirements

on parent company control since the effect would be a direct result of the identity of the holders of the required number of shares and, in particular, their attitude toward cooperation with the American corporate stockholder in matters of business and financial policy. Another similar regulatory measure may involve the requirement that a specified number of the members of the board of directors of the foreign corporation be nationals of the country of incorporation regardless of the ownership of voting shares. The impact of this sort of requirement on the effectiveness of parent company control must also be determined in view of the specific circumstances and in consideration of the attitude of the foreign representatives on the board. It is adequate to conclude that if regulations of the type mentioned above become so restrictive as actually to impair the effectiveness of the control over the activities of the foreign affiliate which may be exercised by the American parent corporation, it is necessary to exclude the foreign affiliate from consolidated statements. The following statement effectively summarizes the possibilities in this area:

> It is hardly likely that a corporation would acquire or establish a foreign subsidiary in the face of local prohibitions effectively preventing control, but the restrictions might very well be enacted subsequently. As a result a continuing examination of foreign business regulations is essential in order to determine whether or not a constituent unit has been converted into a mere foreign investment. As soon as the obstructions become onerous enough to render integrated operations impossible the subsidiary should be dropped from consolidation and the investment therein classified as non-operating.[11]

The second type of restriction which must be considered in reaching a decision as to the existence of effective control over a foreign subsidiary at a particular time, and hence, as to the propriety of including the accounts of the subsidiary in consolidated statements, relates to restrictions on the convertibility of the foreign currency for the purpose of obtaining dollars to remit to the American parent corporation. Examination

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[11] Moonitz, op. cit., p. 36.

of published corporate financial data leads to the conclusion that at the present time this type of restriction has the greatest effect of any of the types discussed here on the decision as to the inclusion of foreign subsidiaries in consolidated reports.

This type of restriction was discussed in detail in the preceding chapter, with particular emphasis at that point on the effect of convertibility restrictions on the recognition of undistributed subsidiary earnings by the parent corporation. It was concluded that restrictions on convertibility in connection with the withdrawal of capital should have no effect on the recognition of undistributed subsidiary earnings by the parent corporation. It was further concluded that restrictions on the withdrawal of funds representing current earnings have no necessary influence on the propriety of parent company recognition of undistributed earnings, the facts of each case in relation to the foreign need for retention of earnings, etc., being the determining factors. Essentially similar conclusions must emerge in regard to the impact of convertibility restrictions on the concept of effective control in connection with the inclusion of foreign subsidiaries in consolidated statements. It appears logically necessary to conclude that restrictions on international capital movements should not be considered as impairing the control exercisable by the parent corporation over subsidiary operations to a degree sufficient to necessitate exclusion of the subsidiary's accounts from consolidation. As was pointed out in the preceding chapter, limitations on the ability of any corporation to make distributions to stockholders which represent a return of invested capital are a traditional part of the legal framework governing the relations between a corporation and its stockholders. Restrictions of this type are not considered to have the effect of impairing the effectiveness of intercorporate lines of control in a strictly domestic situation to a degree

which renders the preparation of consolidated financial statements inadvisable, and there would seem to be no reason to interpret restrictions on capital withdrawals differently in a situation involving a foreign affiliate.

When we turn to an examination of the effect on the concept of control of the existence of restrictions on the convertibility of a foreign currency relative to the remittance of current earnings of a subsidiary to its parent corporation, the situation is not so clear cut as is the case in regard to restricted capital movements. The substantial degree of variability as to the severity of restrictions on the remittance of foreign earnings to an American parent corporation serves to make the formulation of any generally applicable conclusion difficult. It will be recalled from the discussion in Chapter IV that restrictions on currency convertibility for the purpose of remitting foreign earnings may include limitations on the amount of current earnings which may be withdrawn; discrimination as between the country to which earnings may be paid; approval or disapproval of each application for exchange for this purpose based on the merits of the particular case; the making of special arrangements or "deals" with particular American corporations; or outright prohibition on the withdrawal of earnings under any circumstances. This extreme degree of variability, which is further complicated by the possibility of rapid change in the status of particular restrictions as the international financial position of a country changes or as the political environment in a country is altered, makes it essential to emphasize the necessity for considering the specific circumstances of each parent-subsidiary relationship in reaching a decision as to the impact of such restrictions on the existence of effective inter-corporate control and the resulting appropriateness of consolidation. It is certainly desirable, however, to point out some of the significant factors which should

be considered in the formation of such a decision. The following statement serves to summarize the conclusions of one writer in this area, and, in addition to indicate some of the pertinent considerations which may soften the effect of currency restrictions on inter-corporate control:

> In addition to specific restraints on control of local companies, a foreign country may place general obstacles in the way of the free transfer of funds, culminating in some instances in outright prohibition of the export of foreign exchange. So long as the restrictions remain on the financial level merely to force transfers through officially designated channels or to implement some phase of monetary policy, essential unity of operations is not destroyed. The hazards of foreign operations are probably increased but their nature is not materially changed. In a sense restrictions of this type are a commonplace everywhere, except that usually they are imposed by contract, not by governmental decree. For example, a domestic subsidiary may be restrained by a bond indenture from paying dividends or lending money until provision is made for creditors. A curtailment of this kind in domestic affairs is usually not considered severe enough to warrant excluding the subsidiary from consolidation, and complications in foreign affairs may be dealt with in a similar manner.
>
> Where foreign exchange exports are prohibited entirely the traditional basis of international business operations is shorn away. In most instances the basis of continued unified operations is likewise seriously impaired. Assuming no commodity export-import prohibitions other than customary tariff barriers, however, a foreign subsidiary engaged in an extractive industry, processing basic raw materials, or manufacturing may easily continue to operate as an integral part of a far-flung international holding company empire. In such a case, the American parent would finance foreign operations and be reimbursed by bringing out of the foreign country the ores, metals, or manufactured products to be used or sold elsewhere. In a similar manner revenues from foreign sales could be recovered by purchasing raw or finished materials abroad and using them in other phases of a combination's operations. The impact of restrictions on funds transfers must therefore be determined in the light of operations actually carried on and the adjustments available to meet restraints.[12]

The preceding statement emphasizes that the existence of currency restrictions at a particular time does not in itself necessarily impair the effectiveness of the control which an American parent corporation may exercise over a foreign subsidiary. Rather, it is necessary to consider the impact of such restrictions in each case in view of the effect on normal relationships between the parent and the foreign subsidiary and in recognition

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[12] Ibid., pp. 36-37.

of the possible abrogation of some of the usual rights which accompany majority stock ownership. In particular, the power to freely control the administration of corporate funds must be considered. The existence of restrictions which limit or abolish the right of a parent company to initiate the declaration and payment of dividends is not adequate evidence to justify the conclusion that the control typically associated with majority stock ownership is impaired to a degree justifying exclusion from consolidation. Only if, in the absence of such restrictions, dividends would be declared and paid to the parent company in substantial amounts, may it be said that any significant degree of impairment of control results. The following statement indicates a situation in which it is reasonable to conclude that convertibility restrictions are not of substantial importance in relation to control:

> Foreign exchange controls in effect in the various countries had no retarding effect on the transfer of such earnings except in Argentina and Brazil where limited foreign exchange and other conditions have curtailed or stopped the remittance of local earnings. These restrictions, however, have not been serious, primarily because of the need for increased facilities and additional working capital resulting from the programs for increased local manufacture. While this need exists, earnings in these countries have been included, as in the past, as part of the total net earnings.[13]

In summary, it must be concluded that the effect on parent company control of a foreign subsidiary of foreign currency convertibility restrictions cannot be determined in any sort of generalized fashion, but rather the effect of such restrictions in each case must be considered and a decision reached as to the appropriateness of consolidation in the particular case. Probably the most important point to be recognized is that the existence of restrictions is not of itself sufficient evidence to justify the conclusion that control is impaired sufficiently to make consolidation inappropriate. Examination of published financial data tends to create the

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[13]Parke, Davis & Company, Annual Report (1952), p. 12.

impression that in many cases this is the line of reasoning which has been followed, with the result that foreign subsidiaries are excluded from consolidation when, in fact, there has been no effective restriction on the parent company's control of the subsidiary.

The third type of restriction which may be imposed by a foreign government with a resulting effect on the freedom of control which the parent corporation might otherwise exercise relates to restrictions on international transactions at the real rather than the financial level. More specifically the reference at this point is to restrictions on the transfer of commodities such as import or export quotas or prohibitions. Where restrictions of this type exist, particularly where they accompany currency restrictions, the effect on the continued existence of effective control by the American parent corporation is likely to be much more severe than in the case of currency restrictions alone. Resort to commodity remittances to the parent company in lieu of the payment of cash dividends may no longer be available as an escape from the fetters of restricted currency convertibility. Although it is again essential to evaluate the circumstances in a particular case, it is much more likely that the resulting conclusion may be that control is actually impaired with the result that the criteria appropriately applied to the problem of consolidation are no longer adequately fulfilled.

The impact of the existence of an investment in a foreign subsidiary on the observation of the principle of consistency relative to inclusion of the accounts of the subsidiary in consolidated financial statements creates an interesting problem. It will be recalled that this problem was considered in some detail in the preceding chapter in connection with the examination of the propriety of recognition by the parent company of undistributed foreign subsidiary earnings. The conclusion at that point was that while

consistency of accounting and reporting procedures is desirable, it is not satisfactory to insist upon the use of techniques which will lend themselves to permanent application, regardless of changes in the social and political environment. Insistence on the employment of procedures which will not require alteration in view of changed international conditions will result in the exclusion of foreign subsidiaries from consolidated statements under all circumstances because there will always exist the possibility of rapid and/or material alteration in the international financial and internal political position of any country resulting in the imposition of currency or commodity controls of varying degrees of severity. Quite apparently this position cannot result in financial reporting at a level of maximum informativeness.

Consideration of the second fundamental criteria to be applied to the problem of reaching a decision as to the appropriateness of including the accounts of a legally separate corporation in consolidated financial statements, namely that of inclusion within an integrated operating unit will typically not create any problem in the case of investment in a foreign subsidiary. It will be an extremely rare situation in which an American corporation will undertake investment in the form of ownership of a controlling interest in the shares of a foreign corporation when the activities of the foreign subsidiary are not closely related to the principal activities of the parent and domestic subsidiaries. While consideration of the position of a foreign corporation in relation to the operations of domestic affiliates should certainly precede inclusion of the accounts of the foreign subsidiary in consolidated statements, it is reasonable to conclude that there would be few, if any, cases in which exclusion from consolidation would be appropriate because of this factor.

Before leaving the problem of determining the appropriateness of

including the accounts of foreign subsidiary corporations in consolidated statements, it is desirable to examine the recommendations of regulatory bodies and professional societies in this area. The following statements set forth the position of the American Institute of Accountants. It should be noted that these recommendations were drafted in 1939 and presumably reflect the impact of the disturbed international conditions incident to the beginning of World War II.

> 1. The disturbed conditions abroad, and the uncertain future, make it necessary to reconsider the accounting treatment of assets, liabilities, losses, and gains involved in the conduct of foreign business, and included in the financial statements of United States companies.
>
> It is clear that in many cases in which statements of foreign subsidiaries have been consolidated with statements of United States companies this practice can no longer be followed.
>
> 6. The following procedures are among the possible ways of providing adequate disclosure of information relating to foreign subsidiaries:
>
> (a) 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. If these investments include any amount of surplus of foreign subsidiaries and such surplus had previously been included in consolidated surplus, the amount should be separately shown or earmarked in stating the consolidated surplus in the statements here suggested. The exclusion of foreign subsidiaries from consolidation does not make it permissible to include inter-company profits which would be eliminated if such subsidiaries were consolidated.
>
> (b) To consolidate domestic and foreign subsidiaries as hitherto, and to furnish in addition the summary described in (a) (2) above.
>
> (c) To furnish: (1) complete consolidated statements, and also (2) consolidated statements for domestic companies only.
>
> (d) To consolidate domestic and foreign subsidiaries as hitherto, and to furnish in addition parent company statements showing investment in and income from foreign subsidiaries separate from those of domestic subsidiaries.[14]

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[14] American Institute of Accountants - Committee on Accounting Procedure, op. cit., pp. 30-31.

The preceding statement was repeated without alteration in the statement of the Research Department of the American Institute of Accountants dealing with accounting problems related to currency devaluation issued in November, 1949.

Examination of the preceding statement indicates that it has nothing to offer in the way of providing any sort of objective criteria in connection with the decision as to the inclusion of the accounts of foreign subsidiaries in consolidated statements. It merely states that "it is clear that in many cases in which statements of foreign subsidiaries have been consolidated with statements of United States companies this practice can no longer be followed" with no indication of the underlying conditions which render this situation so clear or as to identifying with some sort of objectivity the "many cases" where exclusion from consolidation is the obvious conclusion. Once again, as was the case in connection with professional society recommendations regarding the problems associated with the devaluation of a foreign currency, it must be concluded that the preceding statement is intended more to approve a variety of procedures rather than to reach a conclusion on logical grounds in relation to the problem at hand.

The Securities and Exchange Commission's Regulation S-X, dealing with the form and content of financial statements filed with the Commission, contains the following statement regarding the inclusion of the accounts of foreign subsidiaries in consolidated statements:

> Consolidation of foreign subsidiaries. - Due consideration shall be given to the propriety of consolidating with domestic corporations foreign subsidiaries whose operations are effected in terms of restricted foreign currencies. If consolidated, disclosure should be made as to the effect, insofar as this can be reasonably determined, of foreign exchange restrictions upon the consolidated financial position and operating results of the registrant and its subsidiaries.[15]

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[15]Securities and Exchange Commission, Regulation S-X, 1951, p. 10.

Again we find nothing which comes directly to grips with the problem of reaching a decision as to the propriety of including foreign subsidiaries in consolidated statements. Again the emphasis is on adequate disclosure rather than on the development of any suggested criteria which may be employed in evaluating the effect of exchange and related controls on the desirability of consolidating foreign subsidiaries.

After having examined the position of the American Institute of Accountants and the Securities and Exchange Commission relating to the consolidation of foreign subsidiaries, it is interesting to note the prevailing practices at the present time in regard to the inclusion of foreign subsidiaries in consolidated statements as well as the criteria which are applied in reaching a decision as to inclusion or exclusion. The following tabulation summarizes the results of a survey of the published annual reports of six hundred American corporations, in regard to the consolidation of foreign subsidiaries:

Table 29 - Foreign Subsidiaries

Basis of Consolidation	1951	1950
STATED		
Based on percentage of ownership	25	22
Based on geographical location	13	13
Based on percentage of ownership and geographical location	9	11
No foreign subsidiaries consolidated	32	32
All foreign subsidiaries consolidated	24	23
Some foreign subsidiaries consolidated in income statement only	13	12
Total	116	113
INDICATED		
By inclusion of all foreign subsidiaries in consolidation	45	45
By exclusion of all foreign subsidiaries from consolidation	9	9
Total	54	54
NEITHER STATED OR INDICATED		
Some foreign subsidiaries consolidated	101	100

Number of Companies:		
Referring to foreign subsidiaries	271	267
Not referring to foreign subsidiaries	329	333
	600	600[16]

The preceding tabulation may be summarized as follows:

> Among the 600 companies included in the survey, there were 271 which indicated in their annual reports that they had foreign subsidiaries. Of these companies, 69 either stated or indicated that all foreign subsidiaries were included in the consolidation. There were 41 companies which indicated that no foreign subsidiaries were consolidated. Table 29 shows that 60 of the companies in this group set forth or indicated in their annual reports various bases upon which foreign subsidiaries were included in or excluded from the consolidation. The remaining 101 companies neither stated nor indicated the bases used in determining which of their foreign subsidiaries were included in the consolidation and which were excluded.[17]

It is apparent that the results of this survey do not demonstrate any sort of unanimity of practice in regard to the inclusion of the accounts of foreign subsidiaries in consolidated financial statements or as to the criteria applied in reaching a decision as to the inclusion in or exclusion from consolidated statements. This would seem to reinforce the conclusion of the earlier section of this chapter in which it was emphasized that it is essential to evaluate the impact on effective control of governmental regulations in their various forms before reaching a decision in a specific case relative to consolidation.

Having examined the fundamental criteria which relate to the decision as to the inclusion of the accounts of affiliated corporations in consolidated statements, with particular emphasis on the effect of the affiliate being domiciled in a foreign country, it is now desirable to summarize briefly the conclusions which have been reached. In the general case effective

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[16] American Institute of Accountants-Research Department, Accounting Trends and Techniques in Published Corporate Annual Reports - Sixth Edition, (1952), p. 32.

[17] Ibid., pp. 30-31.

common control of affiliated corporations, coupled with a reasonable degree of homogeneity of operations as between the affiliated entities makes the preparation of consolidated statements for the affiliates desirable. It has been concluded that neither control nor similarity of operations lend themselves to identification by any single index or measuring rod, but rather that careful consideration of the facts of a particular situation in relation to these criteria is essential in order to reach a logical solution. The existence of a foreign subsidiary may cause the introduction of several complicating features into the process of determining whether effective control is present in a degree adequate to justify consolidation. There may exist regulations which encroach directly upon the degree of control exercisable by the parent corporation by requiring a stipulated degree of foreign stock ownership or a minimum number of foreign representatives on the board of directors. In addition, at the present time, it is common to find some degree of restriction on the convertibility of various foreign currencies and also the possibility of direct import-export restrictions, limiting the free movement of commodities. It is not possible to evaluate the impact of restrictions of these types on the effectiveness of control by the parent company in a general way, but rather it is necessary to examine their effect on the degree of control exercisable in a particular case. It is of utmost importance to recognize that the existence of restrictions of the type cited above does not, per se, render the inclusion of the accounts of foreign subsidiaries in consolidated statements inappropriate. It is only in circumstances in which the restrictions actually impinge on the freedom of action in the determination of business policy normally associated with majority stock ownership that exclusion from consolidation is the proper conclusion.

It was concluded that there are few circumstances in which the

existence of investment in a foreign subsidiary would cause any special problems relative to determining the existence or absence of a unified sphere of operations sufficient to justify the preparation of consolidated statements.

Finally, it is the conclusion of this inquiry that, in general, the accounts of foreign subsidiaries should be included in consolidated financial statements in situations in which substantial stock ownership exists and the activities of the foreign corporation are reasonably closely related to those of the American parent company. Exceptions to this general principle may certainly exist in particular circumstances which may cause exclusion from consolidation to represent desirable reporting procedure, but exclusion should be considered preferable only in situations in which the absence of effective control and/or lack of an adequate degree of homogeneity of operations can be clearly demonstrated. In other words, the burden of proof would seem to fall on those favoring exclusion of a foreign subsidiary's accounts from consolidation rather than the opposite situation, which appears to exist at the present time. It would seem that what is called for is not so much concern relative to the inclusion or exclusion of foreign subsidiaries from consolidation but, rather, a more general recognition of the nature of consolidated statements as representing data which are distinctly supplementary to the financial reports of the separate constituent entities.

Special Problems Relating to the Inclusion of the Accounts of Foreign Subsidiaries in Consolidated Statements

In the preceding section it was concluded that, in the general case, it is appropriate to incorporate the accounts of foreign subsidiary corporations in consolidated financial statements. It was further concluded that, in particular situations, restrictions imposed by foreign governments might impair the effectiveness of control exercisable by the domestic parent corporation to a degree which would render consolidation inadvisable, but

that it is essential that the mere existence of restrictions not be considered sufficient grounds to justify exclusion from consolidation in the absence of impairment of control. It will be the objective of the present section to examine some of the problems which are created by the inclusion of the accounts of foreign subsidiaries in consolidated statements, with particular reference to present reporting practices in relation to these problems.

Examination of current periodical literature in this area together with published corporate annual reports leads to the conclusion that the two most important current problems related to the consolidation of foreign subsidiaries are (1) the advisability of including undistributed earnings of foreign subsidiaries in consolidated net income and consolidated retained earnings (particularly when the remittance of earnings is restricted by limited convertibility), and (2) the desirability of segregating or otherwise disclosing the foreign assets and liabilities included in the consolidated balance sheet. Upon closer scrutiny it will be noted that both of these problems are actually concerned with the degree or extent of consolidation which is deemed to be appropriate in a particular situation. For this reason, these problems will be explored and solutions illustrated through the medium of an examination of the varying degrees in which the accounts of a foreign subsidiary may be included with those of American corporations in a consolidated balance sheet and consolidated income statement. It is apparent that, in this connection, there are two limiting cases. In the first place the asset, liability, and operating accounts of the foreign subsidiary may be fully merged with similar accounts in the consolidated statements in the same manner as would typically be done in the case of a purely domestic consolidation. Obviously, in this situation there is no attempt made to treat foreign net assets and earnings any

differently than similar domestic items, at least in the financial statements themselves, although additional explanatory information may be presented in notes or tabulations appended to the statements. In a situation in which consolidation is justified in terms of the criteria developed in the preceding section, this would seem to be the most appropriate consolidating procedure. At the other extreme is the complete exclusion of foreign net assets and earnings from the consolidated statements, with the parent company's investment account included in the consolidated balance sheet at cost (or less) and dividends received from foreign subsidiaries included in the consolidated income statement. This procedure would logically apply to a situation in which, as a result of foreign government restrictions of the type previously examined, effective control of the subsidiary or its position as a part of an integrated operating unit were impaired. Between these two extremes there exist many possible hybrid or partial consolidation methods, the use of which is motivated by a desire to accord special treatment to undistributed foreign earnings and/or to net assets of foreign subsidiaries. It will be the purpose of the following sections of this chapter to examine these possibilities in terms of their effect on the consolidated financial statements.

Special Treatment of Undistributed Foreign Subsidiary Earnings

It was indicated in the preceding paragraph and more extensively in the preceding chapter that one of the principal reporting problems related to foreign investment by an American corporation relates to the desirability of giving recognition in the accounts of the American parent corporation or in consolidated statements to earnings of the foreign subsidiary which have not been remitted to the United States. This problem has become particularly significant in situations in which the availability of foreign assets is limited because of the existence of restrictions on the convertibility of the

foreign currency. The position of the American Institute of Accountants on this point is summarized in the following statement, part of which was presented in another connection at an earlier point in this inquiry:

> As to earnings, 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 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. In other words, the position shown should not be made better by the omission of foreign results.
>
> Any earnings to be reported beyond the amounts already received in the United States should be carefully considered in the light of all the facts. The amounts should be disclosed if they are significant and they should be reserved against to the extent that their realization in dollars may be doubtful.[18]

It will be noted that the preceding statement refers to recognition by United States corporations of foreign earnings "in their own accounts." There would seem to be good reason to believe that a similar point of view would apply to the inclusion of foreign earnings in consolidated net income.

Since the general area of recognition of undistributed foreign earnings was considered in detail in the preceding chapter, the discussion at this point will be restricted to an examination of various procedures related to the recognition of foreign earnings in consolidated statements, without repeating the considerations relative to the desirability or undesirability of such recognition.

The limiting cases in relation to inclusion of the accounts of foreign subsidiaries in consolidated statements which were mentioned above, e.g., full consolidation or no consolidation are certainly applicable to foreign earnings. The reporting problems related to the application of either of these concepts may be said to be substantially, if not exclusively, related to disclosure of information relating to foreign subsidiaries which the consolidated statements themselves do not display.

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[18] American Institute of Accountants - Committee on Accounting Procedure, op. cit., p. 30.

Turning first to the case in which the earnings of foreign subsidiaries are fully included in the consolidated financial statements, regardless of dividend remittance or retention abroad, the type of information which would seem to be appropriately disclosed, if any is necessary, would be the total amount of foreign earnings included in the consolidated income statement and the part of this total which was not remitted to the parent corporation in the form of dividends. This procedure would be in line with the recommendation of the American Institute that, in connection with foreign earnings reported beyond the amount already received in the United States, "the amounts should be disclosed if they are significant." On the other hand, however, there may be good reason to consider that the disclosure of unremitted foreign earnings is no more a proper part of required procedure than comparable disclosure of unremitted domestic subsidiary earnings included in consolidated net income. If the environment, in terms of foreign government restrictions, is such that inclusion of the accounts of the foreign subsidiary in consolidated statements is appropriate in relation to the criteria previously established, it may be concluded that special disclosure of unremitted foreign earnings will only serve to cast doubt on the validity of the decision to consolidate the results of foreign operations. The situation is somewhat comparable to the apparent effect on the apparent propriety of employing the last-in, first-out concept of inventory pricing of the parenthetic disclosure of current replacement costs of inventory items. It is interesting to note that it is difficult to discover examples of disclosure of total foreign earnings included in consolidated net income in the published financial reports of corporations which fully consolidate foreign earnings. As an example, consider the case of Parke, Davis & Company, which includes foreign earnings in its consolidated income statement whether remitted or not. The following note is appended to the consolidated statements:

> Foreign earnings have been included in the statement of net earnings on the basis of the applicable rates of exchange in effect during the year. Of the total earnings of the year from foreign operations, including direct sales to foreign customers, $1,490,000 was realized in other than United States funds.[19]

The preceding notation gives no indication of the total earnings from foreign operations which were included in consolidated net income indicating only the amount of the total which was not realized in United States dollars.

In a case in which the accounts of a foreign subsidiary are excluded from consolidated statements it is common to find, in addition to the formal financial statements, a tabulation setting forth the dollar value of foreign net assets and earnings and the equity of the parent corporation in foreign earnings. This is in general agreement with the first suggested alternative to complete consolidation offered by the American Institute of Accountants and presented in this chapter on page 221. An example of this procedure is shown in the following tabulation, taken from the 1950 annual report of International Harvester Company. An identical tabular arrangement has been employed in the 1951 and 1952 annual reports of this Company.

This tabulation gives a comparison of the Company's investment in subsidiaries at October 31, 1950, with its equity in their net assets. It also shows a comparison of the Company's equity in the 1950 net income of subsidiaries, and the cash dividends received from them.

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[19] Parke, Davis & Company, op. cit., p. 12.

Areas in Which Subsidiaries Operate	Investment in Subsidiaries at Oct. 31, 1950	Equity in Net Assets of Subsidiaries at Close of Their 1950 Fiscal Years	Equity in the 1950 Net Income of Subsidiaries	Cash Dividends Received from Subsidiaries in 1950
Canada	$15,220,000	$ 36,217,000	$ 6,731,000	$1,819,000
Latin America	15,501,000	28,596,000	3,000,000	1,195,000
Europe	13,055,000	32,916,000	4,830,000	1,122,000
Africa	888,000	3,881,000	(371,000)	278,000
Australia, New Zealand, and Philippines	12,870,000	23,613,000	(943,000)	915,000
IH Export Company (A)	10,463,000	15,347,000	1,564,000	3,000,000
United States	30,002,000	32,960,000	2,195,000	32,000
Total	$97,999,000	$173,530,000(B)	$17,006,000(C)	$8,361,000(D)

(A) The International Harvester Export Company derived its income from sales to foreign subsidiaries and jobbers.

(B) Of this $173,530,000 equity, $33,810,000 was invested in fixed property and $139,720,000 in working capital.

(C) Losses sustained in Africa, Australia, and New Zealand were due to devaluations of currencies in those countries.

(D) Cash dividends are before deductions for withholding taxes, etc., amounting to $584,000.[20]

Burroughs Adding Machine Company presented the following financial statements showing the combined results of operations of foreign subsidiaries in its 1950 annual report. At this time Burroughs was not including foreign subsidiary accounts in its consolidated statements, but has since adopted a semi-consolidation procedure which will be discussed and illustrated in the next section.

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[20] International Harvester Company, Annual Report (1950), p. 10.

BURROUGHS ADDING MACHINE COMPANY
Combined Statements of Subsidiary Companies Operating in Other Countries
Statement of Operations

	1950	1949
Charges to customers for products sold and services rendered	$23,240,617	$17,833,485
Miscellaneous income	53,957	52,238
	$23,294,574	$17,885,723
Costs and expenses	18,560,157	14,386,330
	$ 4,734,417	$ 3,499,393
Estimated taxes on the year's income	2,405,000	1,470,000
Net income for the year	$ 2,329,417	$ 2,029,393
Dividends paid to parent company	1,678,460	1,708,462
	$ 650,957	$ 320,931
Income of prior years not paid in dividends to parent company	3,840,332	3,757,688
Excess of purchase price over book value of net assets of Canadian company acquired in 1949	-	(212,412)
Income transferred to capital stock	(109,137)	(25,875)
Income not paid in dividends to parent company at end of year	$ 4,382,152	$ 3,840,332[21]

Standard Brands, Incorporated excludes foreign subsidiaries, other than Canadian, from both the consolidated balance sheet and consolidated income statement and presents, in addition to the consolidated statements, combined statements of financial position and operations for all subsidiary corporations located outside of the United States and Canada.

Having briefly examined reporting practices in situations in which subsidiary earnings are fully consolidated and in which there is no consolidation of subsidiary earnings with only dividends received being considered as a part of consolidated net income, it is now appropriate to turn to an examination of reporting techniques which represent a middle ground between these two extremes. In general, these procedures may be characterized as

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[21]Burroughs Adding Machine Company, Annual Report (1950), p. 16.

resulting in the inclusion of foreign earnings in the consolidated statement of income in the same manner as would be done in a case in which complete consolidation was contemplated but deducting from the combined net income of foreign and domestic affiliates an amount representing the unremitted foreign earnings. This income statement charge is offset by a credit to an account which, together with the amount of accumulated unremitted foreign subsidiary earnings from past years, is presented in one of several places in the consolidated balance sheet. The end result of this procedure in terms of the amount of net income reported in the consolidated income statement is exactly the same as though only dividends received from foreign affiliates had been given recognition, but consolidated revenues and expenses are stated in terms of the totals of related items for all affiliated corporations. Once again our major interest at this point is not to consider the propriety of recognition or non-recognition of undistributed foreign earnings, this having been done in the preceding chapter, but rather to examine the reporting techniques which have been developed to give special recognition to such earnings.

An examination of published corporate financial statements leads to the conclusion that some sort of hybrid consolidation procedure of the type described in the preceding paragraph represents the most common current technique for dealing with the problem of foreign earnings. Numerous examples of consolidated income statements giving effect to this procedure could be presented but only two illustrations will be presented and examined.[22] The first case which will be offered is that of The Gillette Company, the 1952 consolidated income statement of which is presented below.

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[22]Among the companies employing this method are United States Rubber Company, National Cash Register Company, The Gillette Company, Goodyear Tire and Rubber Company, Coca-Cola Company, Vick Chemical Company, and General Motors Corporation.

THE GILLETTE COMPANY
AND SUBSIDIARY COMPANIES
Consolidated Statement of Income and United States
Earned Surplus
Year Ended December 31, 1952

Net Sales		$120,484,625
Cost of sales		41,811,240
Gross Profit		78,673,385
Operating expenses		42,775,824
Profit from operations		35,897,561
Dividends and royalties received from a subsidiary not consolidated		263,921
Other royalties received		101,798
Interest received		567,050
Gain on foreign exchange		65,680
Other income		13,777
		36,909,787
Deduct:		
Depreciation		1,305,077
Interest paid		19,392
Provision for United States and foreign income and excess profits taxes		19,185,546
		20,510,015
		16,399,772
Deduct net amount of current earnings in foreign countries not realized in United States dollars		1,687,006
Net income for the year, before special charges		14,712,766
Deduct special charges to write off goodwill resulting from increase during current year in investment in The Toni Company		2,156,445
Net income, after special charges, transferred to earned surplus		12,556,321
United States earned surplus at January 1, 1952		29,293,380
		41,849,701
Add realization of previously unremitted foreign earnings		31,908
		41,881,609
Deduct dividends:		
$5.00 Dividend Convertible Preference Stock	$1,407,255	
Common Stock	9,986,145	11,393,400
United States earned surplus at December 31, 1952		$ 30,488,209[23]

Several items included in the preceding income statement merit comment. In the first place, it will be observed that foreign revenues,

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[23]The Gillette Company, Annual Report (1952), p. 12.

costs, and expenses are merged with like items relating to domestic affiliates with the result that the profit from operations as well as the profit before and immediately after the deduction of income and excess profits taxes reflect complete consolidation of the revenue and expense accounts of foreign and domestic subsidiary corporations. Following the deduction of United States and foreign income and excess profits taxes the amount of current earnings in foreign countries not realized in United States dollars is deducted in order to place foreign earnings included in consolidated net income on a cash or remittance basis. At a later point in the statement, in fact in the section which represents an analysis or statement of earned surplus, an amount is added to the beginning earned surplus representing the amount of prior years earnings which were realized by dividend remittances during 1952. There may be reason to question the validity of presenting this amount in the form of a correction of the beginning earned surplus, since, if it is desired to include foreign earnings in net income only to the extent realized by dividend remittances the proper amount to include in 1952 consolidated net income would be the total amount received in dividends during 1952, not the amount of 1952 foreign earnings remitted during 1952. The terminology used in both the title of the statement and in the section dealing with an analysis of 1952 changes in earned surplus merit comment. At both of these points, the term "United States earned surplus" is employed. This clearly indicates the effect of excluding unremitted foreign earnings from consolidated net income and consolidated earned surplus with the result that the amount described as United States earned surplus represents only net assets within the United States.

Another example of partial consolidation procedure in relation to foreign earnings is available in the case of Burroughs Adding Machine Company. This company also follows the practice of combining domestic and foreign

revenues and expenses in the consolidated income statement and deducting from the net income figure developed in this manner the amount which represents retained foreign earnings for the year. The following section of the 1952 consolidated income statement of Burroughs illustrates the application of this procedure:

BURROUGHS ADDING MACHINE COMPANY
Statement of Operations

	1952	1951
COMBINED NET INCOME FROM OPERATIONS IN ALL COUNTRIES	$9,001,984	$10,615,378
Less portion of combined net income retained in foreign operations	1,108,565	3,026,654
NET INCOME FOR THE YEAR from operations in the U.S. and Canada including dividends received from foreign operations	$7,893,419	$ 7,588,724[24]

Numerous other applications of this sort of procedure could be cited, but the general result of all would prove to be identical, namely to include in specific revenue and expense items both foreign and domestic amounts and by deduction of the amount of unremitted foreign profits to arrive at the same result in terms of consolidated net income as though only dividends received from foreign subsidiaries had been included in consolidated net income.

An interesting reporting problem which is created by the technique described above of deducting unremitted subsidiary earnings in the process of arriving at consolidated net income is the balance sheet classification of the credit element which offsets the income statement charge. It seems that current practice in this connection falls into one of three categories. Probably the most common procedure is to present the credit element which represents accumulated undistributed foreign earnings in a separate reserve category on the credit side of the balance sheet. This procedure may be

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[24]Burroughs Adding Machine Company, Annual Report (1952), p. 19.

illustrated by the following abstract from the December 31, 1952 balance sheet of General Motors Corporation.

	Dec. 31, 1952	Dec. 31, 1951
RESERVES:		
Unremitted profits of consolidated foreign operations which were largely reinvested abroad	73,355,859	89,146,494[25]

The December 31, 1952 balance sheet of Coca-Cola Company includes the following on the right hand side:

RESERVES:	
For unremitted foreign profits	$23,243,107.98[26]

In both of the cases cited above the reserve caption appears on the balance sheet between liabilities and stockholders' equity. Numerous other examples could be presented of cases in which the credit balance account representing unremitted subsidiary earnings is classified in a reserve category on the credit side of the balance sheet. In many of these cases a general reserve related to foreign operations is employed which not only includes accumulated unremitted profits of foreign subsidiaries but also an estimated provision for possible future loss due to shrinkage in the dollar value of foreign net assets.

A second method of dealing with the credit element representing unremitted subsidiary earnings is to consider it as a part of consolidated net worth, clearly identified as representing the amount of accumulated undistributed foreign earnings. This technique may be illustrated by the Stockholders' Equity section of the December 31, 1952 balance sheet of The Gillette Company, which is presented below.

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[25]General Motors Corporation, Annual Report (1952), p. 41.

[26]Coca-Cola Company, Annual Report (1952), p. 5.

STOCKHOLDERS' EQUITY:

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EARNINGS RETAINED IN THE BUSINESS:

Earnings retained in foreign businesses of subsidiary companies pursuant to statutory requirements	$ 325,308	
Other earnings retained in foreign businesses of subsidiary companies - Note 2	6,122,402	[27]
United States earned surplus	30,488,209	$36,935,919

Note 2 to the consolidated balance sheet presents the following analysis of changes during 1952 in other earnings retained in foreign businesses of subsidiary companies:

Amount at January 1, 1952		$4,957,336
Deduct:		
Realization of earnings earned prior to January 1, 1949	$ 31,908	
Write off of goodwill arising from acquisition of a foreign company	490,032	521,940
		$4,435,396
Add net amount of current earnings in foreign countries not realized in United States dollars		1,687,006
Amount at December 31, 1952		$6,122,402[28]

In addition to the preceding tabulation, Note 2 divides the December 31, 1952 balance of foreign retained earnings as follows:

Remitted subsequent to December 31, 1952, but prior to the date of the annual report	$ 390,000
Retention of earnings beyond current requirements	2,436,000
Amount required to carry on respective businesses	3,296,000
Total	$6,122,000[29]

No indication is given as to the method employed to arrive at the "amount required to carry on respective businesses" as compared with "retention of earnings beyond current requirements." This problem will be explored in a subsequent section of this chapter with particular reference to the problem of statement presentation of the asset elements retained by a foreign

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[27] The Gillette Company, op. cit., p. 13.

[28] Ibid., p. 15.

[29] Ibid., p. 15.

affiliate in excess of current operating needs.

The 1952 annual report of Burroughs Adding Machine Company presents another example of reporting foreign retained earnings as an earmarked part of consolidated net worth. The following tabulations represent the Stockholders' Investment section of the statement of financial condition and the related statement of Income Invested in the Business:

BURROUGHS ADDING MACHINE COMPANY
Statement of Financial Condition

Stockholders' Investment

	December 31 1952	December 31 1951
NON-PAR VALUE STOCK, 5,000,000 shares authorized and issued	$25,000,000	$25,000,000
Less cost of 2,610 shares held by the company	40,547	40,547
	$24,959,453	$24,959,453
INCOME INVESTED IN THE BUSINESS:		
Parent company and subsidiary companies operating in the U.S. and Canada	34,679,894	31,284,126
Subsidiary companies operating in other countries	7,763,069	6,654,504
	$67,402,416	$62,898,083

Income Invested in the Business

PARENT COMPANY AND SUBSIDIARY COMPANIES OPERATING IN THE U.S. AND CANADA:		
Net income for the year	$ 7,893,419	$ 7,588,724
Dividends paid to stockholders - $.90 a share	4,497,651	4,497,651
	$ 3,395,768	$ 3,091,073
Income of prior years invested in the business	31,284,126	28,193,053
	$34,679,894	$31,284,126
SUBSIDIARY COMPANIES OPERATING IN OTHER COUNTRIES:		
Net income for the year (eleven months ended November 30 in 1952)	$ 2,912,630	$ 4,310,473
Dividends paid to parent company	1,804,065	1,283,819
	$ 1,108,565	$ 3,026,654
Income of prior years invested in the business	6,654,504	3,627,850
Income at end of year (November 30 in 1952) invested in the business	$ 7,763,069	$ 6,654,504[30]

[30]Burroughs Adding Machine Company, op. cit., p. 19.

A reporting technique which represents a slight modification of that described above is employed by Armour and Company. Armour does not effect any consolidation of the operating accounts of foreign subsidiaries, reporting dividends received as revenue on the consolidated income statement. The investment in foreign subsidiaries is carried on the consolidated balance sheet at an amount representing Armour's equity in the net assets of the foreign subsidiaries, thus requiring some balance sheet recognition of undistributed subsidiary earnings. This amount is treated as a part of consolidated net worth, but, in contrast to the examples just presented, is shown under the caption Capital and Paid-in Surplus, as shown in the following section of the November 1, 1952 balance sheet.

CAPITAL AND PAID-IN SURPLUS:
Parent company and domestic subsidiaries
Foreign subsidiaries (undistributed earnings)[31]

In a situation in which it is felt that the effect of restrictions imposed by foreign governments is not so severe as to render the consolidation of the operating accounts of foreign affiliates inappropriate, but it is desired to give special financial statement recognition to the existence of unremitted foreign earnings, both in the income statement and balance sheet, the method illustrated in the preceding examples would seem to represent a satisfactory procedure. Consolidated net income is calculated on a cash remittance basis in relation to foreign earnings, but the balance sheet is not affected beyond the segregation in the net worth section of foreign as opposed to domestic retained earnings.

A third method which may be employed in the presentation of foreign retained earnings when such earnings are deducted in arriving at consolidated net income is to show the credit element as a deduction from foreign net assets in the consolidated balance sheet. This technique is necessarily

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[31] Armour and Company, Annual Report (1952), p. 11.

related to the question to be examined in the next section, namely, the desirability of isolating in some manner the foreign net assets which are included in the consolidated balance sheet, since its use presumably requires the presentation of foreign net assets in a single amount on the consolidated balance sheet. An example of this procedure is available in the case of National Cash Register Company. In this situation, consolidated net income is calculated by merging domestic and foreign revenues and expenses and deducting from the net income resulting from this procedure the amount of unremitted foreign earnings for the period. A detailed geographical balance sheet of foreign subsidiaries is presented and from the net assets shown on this statement is subtracted minority interests in foreign subsidiaries and accumulated earnings of foreign subsidiaries not remitted to the United States. The resulting amount is shown on the consolidated balance sheet under an investment caption. In effect, this procedure causes the investment in foreign subsidiaries to appear in the consolidated balance sheet at an amount which represents the equivalent original dollar investment (cost). With the exception of the revenue and expense classifications on the consolidated income statement the results of this procedure in terms of both the consolidated income statement and consolidated balance sheet are the same as though no consolidation of foreign subsidiaries had been undertaken.

In the thought that it may make the various hybrid or quasi-consolidation procedures described in the preceding pages more clear and to permit the examination of a related problem, a brief hypothetical illustration will be presented. Since the principal concern at this point is with the impact of partial consolidation techniques on the reporting of foreign earnings, the problem of the presentation of foreign assets on the consolidated balance sheet will be minimized. Assume the following circumstances:

(1) A United States company organized a foreign subsidiary by the investment of $100,000.

(2) The operating record of the foreign subsidiary during the first two years of its existence appears as follows (expressed in foreign currency units):

Year	Net Income	Dividends Paid
1	250,000	-0-
2	100,000	50,000
Total	350,000	50,000

(3) The exchange rate during the two year period was five foreign currency units to one dollar. On the last day of the second year the rate changed to six currency units to one dollar as a result of market forces.

Entries will be prepared in general journal form to summarize the effect on consolidated statements of the operations of the foreign subsidiary. For simplicity, summary account titles will be employed, e.g., foreign net assets and foreign earnings, rather than specific asset, liability, revenue, and expense account titles.

Year 1

Foreign net assets	100,000	
Cash		100,000
To record investment in foreign subsidiary.		
Foreign net assets	50,000	
Foreign earnings		50,000
To record dollar value of foreign subsidiary earnings.		
Provision for unremitted foreign earnings	50,000	
Reserve for unremitted foreign earnings		50,000
To eliminate unremitted foreign earnings from consolidated net income.		

The consolidated income statement for Year 1 would reflect $50,000 excess of revenue over expenses incorporated in various related domestic revenue and expense categories, with the provision for unremitted foreign earnings being deducted in arriving at consolidated net income. This would

cause consolidated net income to be unaffected by the inclusion of foreign revenues and expenses in the consolidated income statement.

The consolidated balance sheet at the end of Year 1 would include $150,000 representing the dollar value of foreign net assets. The reserve for unremitted foreign earnings would be presented in one of the three ways discussed and illustrated in the preceding section. These alternatives included classification in a reserve category, inclusion in consolidated net worth designated as foreign retained earnings, or subtracted from foreign net assets or conceivably total consolidated assets. If the last procedure is employed it will cause the consolidated balance sheet to reflect foreign net assets at their present dollar equivalent of $150,000 less the reserve of $50,000, or a net amount of $100,000 which represents the original dollar investment.

Year 2

Foreign net assets	20,000	
Foreign earnings		20,000
To record dollar value of foreign subsidiary earnings.		
Cash	10,000	
Foreign net assets		10,000
To record receipt of dividend.		
Provision for unremitted foreign earnings	10,000	
Reserve for unremitted foreign earnings		10,000
To eliminate unremitted foreign earnings from consolidated net income.		

Thus far no recognition has been given to the alteration in the rate of exchange from five foreign currency units to one dollar to six foreign currency units to one dollar. The effect of this change will be examined after observing the results, in terms of the consolidated financial statements, of the entries made thus far.

The consolidated income statement for Year 2 would include foreign revenues and expenses resulting in a net income of $20,000. In addition, it

would include a deduction of $10,000 representing the unremitted foreign earnings, resulting in a net amount of $10,000 being reflected in consolidated net income on account of foreign operations. This amount is, of course, equal to the dollar value of the dividend received during Year 2 from the foreign subsidiary.

The consolidated balance sheet at the end of Year 2 would include various foreign asset and liability items producing a net asset amount of $160,000. This is equal to the foreign currency amount of net assets of the subsidiary (800,000) translated at the exchange rate of five to one which has prevailed during Years 1 and 2. The balance sheet would also include the reserve for unremitted foreign earnings with a balance of $60,000, which represents the dollar value of foreign retained earnings of 300,000 foreign currency units translated at a rate of five foreign currency units to one dollar. As previously discussed, this reserve could be presented in the consolidated balance sheet in a reserve category, as a part of consolidated net worth, or as a deduction from foreign net assets. The latter technique would, as previously pointed out, produce the same effect as though the investment in the foreign subsidiary had been carried at the original dollar cost of $100,000 ($160,000 of foreign net assets less the reserve of $60,000).

Let us now turn to the effect of the reduction in the dollar value of the foreign currency, measured by the change in the rate of exchange from five to one to six to one. It is apparent that the exact magnitude of the effect of this change on the dollar value of the net assets of the foreign subsidiary will depend upon the relative amounts of money-value as compared with non-money-value net assets included in the total subsidiary net assets of 800,000 foreign currency units. For illustrative purposes, it will be assumed that subsidiary net assets at the end of Year 2 consist of net money-value assets of 600,000 currency units and non-money-value assets of

200,000 currency units. Under this assumption, the movement in the rate of exchange will cause a decrease in the dollar value (exchange loss) of the net assets of the foreign subsidiary of $20,000. This amount represents the difference between the dollar value of the 600,000 of net money-value assets translated at a rate of five to one ($120,000) and the same number of foreign currency units expressed in dollars at an exchange rate of six to one ($100,000). It will be recalled that in the discussion of the problems related to exchange gains or losses in Chapter IV, it was concluded that exchange gains or losses should be reported as a part of the over-all operating results of the foreign subsidiary. However, at this point our immediate concern is related to the question of inclusion of foreign earnings in consolidated financial statements. Since, with the use of the technique under examination in this illustration the only effect of foreign operations on consolidated net income is that measured by dividends received from the foreign subsidiary, it hardly seems appropriate to include exchange gains or losses in consolidated earnings. Rather, the exchange gain or loss is actually a revaluation of net money-value assets retained by the foreign subsidiary. Since the reserve for unremitted foreign earnings is a measure of the increase in foreign net assets above the original investment by the parent company, it would appear logical to consider that the exchange gain or loss should be treated as an adjustment of this element. Using the facts of the present illustration, it would seem that the exchange loss of $20,000 should be treated as a reduction in the reserve for unremitted foreign earnings giving effect to the decrease in the dollar value of the net assets represented by foreign retained earnings. This would reduce the reserve to a balance of $40,000 which represents the dollar value of foreign retained earnings expressed in terms of the presently effective exchange rate of six to one. The following balance sheet showing the determination of the dollar

value of subsidiary net assets after the alteration in the rate of exchange will make the source of the dollar magnitudes cited above more apparent.

A FOREIGN SUBSIDIARY
Balance Sheet
End of Year 2

	Foreign Currency Units	Translation Rate	Dollars
Net money-value assets	600,000	6 (Current rate)	$100,000
Non-money-value assets	200,000	5 (Acquisition rate)	40,000
	800,000		$140,000
Capital stock	500,000	5 (Issuance rate)	$100,000
Retained earnings-before change in rate	300,000		60,000
- exchange loss			(20,000)
	800,000		$140,000

The entry to record the effect on the consolidated accounts of the change in the current rate of exchange would be:

Reserve for unremitted foreign earnings	20,000	
Foreign net assets		20,000
To record the decrease in dollar value of foreign net assets caused by exchange rate movement.		

If the reserve for unremitted foreign earnings is deducted from foreign net assets in the consolidated balance sheet, the preceding entry will have no effect on consolidated net assets since it reduces foreign net assets and the contra reserve by the same amount.

The preceding section has examined various alternative techniques of reporting foreign earnings in consolidated financial statements. The possibilities range from full consolidation of the results of foreign operations to complete exclusion of any effect of foreign operations on consolidated net income, except to the extent that dividends have been received from the foreign affiliate. The most interesting area is that which lies between these two extremes and involves partial consolidation of foreign operating results. This typically involves including foreign revenues and expenses

with related domestic classifications and deducting from the net income computed on this basis the amount of unremitted foreign earnings. Consolidated net income is thereby influenced only by dividends received from the foreign affiliate. This procedure requires a decision as to the presentation on the consolidated balance sheet of the credit which offsets the consolidated income statement charge for unremitted foreign earnings. The possible alternatives in this connection include classification of this amount in consolidated net worth, clearly identified, classification in a reserve category, or presentation as a deduction from net foreign or total consolidated assets. The effect of each of these possibilities on the consolidated balance sheet has been indicated in the preceding discussion and the related illustration.

Recognition of the Liability for United States Income and Excess Profits Taxes on Unremitted Foreign Earnings

As a preliminary to this section, it is necessary to summarize briefly the status of earnings and dividends of a foreign subsidiary in relation to United States income taxes. In the first place, it is necessary to recognize that foreign earnings are taxable to the United States parent corporation only when received by the parent in the form of dividends. In addition, the Internal Revenue Code permits the United States corporation to claim a credit against United States income taxes for foreign taxes paid by the foreign subsidiary on income distributed to the domestic parent corporation.[32] In order to qualify for this credit the United States corporation must own at least 10% of the voting stock of the foreign affiliate.

A brief example will serve to clarify the method of calculating the foreign tax credit. Assume that a foreign subsidiary, more than 10% of the stock of which was owned by a United States corporation, had a net income before foreign income taxes of $50,000. The foreign income taxes applicable

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[32]Section 131 (f).

to this income amounted to $15,000, leaving an amount of $35,000 after deduction of foreign income taxes. This amount is described in the Code as "accumulated profits." Out of this $35,000 the foreign subsidiary remits a dividend to the United States parent corporation of $20,000. The foreign tax credit is computed by first calculating the foreign income tax applicable to the accumulated profits, which in this case would be $\frac{35,000}{50,000}$ of $15,000, or $10,500. The next step is to compute the portion of this $10,500 which relates to the income remitted to the parent corporation, which would be $\frac{20,000}{35,000}$ of $10,500, or $6,000. This is the amount which is deemed to have been paid by the United States corporation and which can be applied by it against its liability for United States income taxes. It will be noted that the result of the preceding calculation is the same as though the foreign income tax ($15,000) had been multiplied by a fraction representing the portion of the total net income of the foreign subsidiary which was paid to the United States parent corporation in the form of dividends $\frac{(20,000)}{(50,000)}$. The foreign tax credit, calculated in this manner, is subject to two limitations, described in the following paragraph:

> In the case of a corporation, the credit for tax paid to any one country cannot exceed the proportion of the U.S. income tax against which the credit is taken, which the corporation's normal-tax net income from sources within the foreign country bears to its entire normal-tax net income for the same taxable year; and the total credit cannot exceed the proportion of the U.S. income tax which the normal-tax net income from all sources without the U.S. bears to the entire normal-tax net income for the same taxable year.[33]

Having summarized the pertinent provisions of the Internal Revenue Code, it is now appropriate to examine the problems, if any, which United States and foreign income taxes create in connection with the inclusion of the accounts of a foreign subsidiary in consolidated financial statements. It would seem that the only problem of consequence relates to the inclusion

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[33]Commerce Clearing House, Master Tax Guide, (1952), p. 315.

in consolidated statements of foreign earnings not yet remitted to the United States which will not be subject to United States income taxes until remitted. It is immediately apparent that this problem will not exist in situations in which only remitted foreign earnings are included in consolidated net income, since in this situation both foreign and United States income taxes applicable to the reported consolidated net income are also reflected in the consolidated financial statements. It is in the case in which foreign earnings are fully consolidated that the problem of additional United States income taxes on future remittances of current profits requires consideration.

This problem may be illustrated by reference to the amounts employed above to illustrate the calculation of the foreign tax credit. It will be recalled that in this case the foreign subsidiary had net income after foreign income taxes of $35,000, of which $20,000 was paid to the United States parent as a dividend, the remaining $15,000 being retained by the foreign affiliate. If the accounts of the foreign corporation are fully consolidated with those of the domestic parent, the consolidated income statement will include $15,000 of unremitted foreign earnings without recognition of the United States income tax liability which will apply to this $15,000 when it is remitted to the parent company. The question which then arises is whether the omission of this future United States tax liability results in unsatisfactory reporting of consolidated financial position and operating results. In order to reach a decision in this connection it is essential to ascertain the materiality of the tax charge and related liability pertaining to the unremitted foreign earnings which is not reflected on the consolidated statements for the current period. If we assume a 50% rate for United States income taxes and also assume that a dividend at least equal to the $15,000 of retained foreign earnings is remitted to the parent

corporation during the first 60 days of the second year, the net effect on the liability for United States income taxes during the second year may be computed as follows:

United States income tax on dividend received - 50% of $15,000	$7,500
Less foreign tax credit: 15,000/50,000 of $15,000	4,500
Net tax on retained foreign earnings	$3,000

It is obvious that the magnitude of the net tax liability on retained foreign earnings will vary in relation to the direction and amount of the difference between foreign and domestic tax rates. In the present illustration we have assumed a foreign income tax rate of 30% and a United States tax rate of 50%, hence the net tax liability on foreign retained earnings is equal to the differential United States tax rate of 20% multiplied by the $15,000 of retained earnings. If the foreign income tax rate had been 50% (or greater) the foreign tax credit would have offset the United States tax liability in full. Hence, only in situations in which the foreign tax rate is substantially less than the United States rate will the omission of the liability for United States income taxes on unremitted foreign earnings have a material effect on the consolidated statements. In the typical case it seems reasonable to conclude that it should not be considered to be necessary reporting procedure to give recognition in the consolidated statements to United States income taxes on unremitted foreign earnings. For the year 1950 there was a United States income tax liability of 276.7 millions of dollars related to total direct foreign investment. The total related foreign tax credit amounted to 411.1 millions of dollars. Only in the case of Latin American republics was there any net United States tax liability after recognition of the foreign tax credit and in this area the foreign tax credit amounted to over ninety per cent of the gross United States income tax liability.[34]

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[34] United States Department of Commerce - Office of Business Economics, op. cit., p. 29.

It is again convenient to consider the analagous case involving a strictly domestic parent-subsidiary corporation relationship. The same problem exists in this situation in any case in which the affiliated group does not file a consolidated income tax return. In a domestic situation the inclusion of retained subsidiary earnings in consolidated net income may also create some inconsistency between consolidated income subject to income taxes and the tax charge and liability shown on the consolidated statements, since there will be additional United States income tax on the transfer of subsidiary earnings to the parent corporation equal to the tax rate in effect at the time of the transfer multiplied by 15% of the amount remitted. The 15% represents the amount which cannot be claimed as a credit against net income under the 85% dividends received credit. In this situation the typical immateriality of the amounts involved and the necessity of predicting future tax rates result in this potential future tax liability being ignored in domestic consolidated statements. The following statement represents a summary of the replies received from a group of practicing accountants in regard to the necessity of making a provision for prospective taxes on transfers of undistributed earnings of consolidated domestic or foreign subsidiaries:

> There was general agreement here that, in most cases, no provision for potential taxes on possible transfers of a subsidiary's earnings should be made. It was pointed out that a tax results only if and when actual transfers of funds between entities are made and that a tax on subsidiary earnings may never materialize since the undistributed earnings of a subsidiary may be subsequently capitalized, offset by future losses, or otherwise never distributed. Further, prospective tax rates are difficult to estimate with accuracy, and are highly speculative because subject to future change.
>
> The provision may also be omitted on the ground of immateriality due to the 85% dividends received and foreign tax credits. It was also indicated that a provision based on tax rates in effect at the balance-sheet date may be advisable when there is a firm intention

to transfer unblocked foreign earnings and when such earnings are material in relation to consolidated earned surplus.[35]

As the last sentence of the preceding statement indicates there may be circumstances in which the effect on consolidated statements of the omission of any recognition of United States income tax on future transfer of foreign earnings may be material. As previously mentioned this is most likely to be the case in situations in which the foreign tax rate is substantially lower than the United States rate. In these circumstances a provision for such future taxes may be introduced into the consolidated income statement with a related addition to the tax liability shown on the consolidated balance sheet. Using the amounts employed in the preceding illustration, the amount of this provision would be $3,000. When foreign earnings were actually transferred, $3,000 of the actual tax liability attributable to the receipt of dividends from the foreign affiliate would be charged to the tax liability previously recorded rather than considered as being applicable to the period in which the dividends were received. In view of the tentative nature of the amount of future tax resulting from the necessity of predicting future tax rates, it would seem to be preferable procedure to disclose the potential future tax liability by footnote to the consolidated statements rather than by adjustment of the income tax provision and related liability account. However, in most cases the amounts involved may be considered to be immaterial as a result of the foreign tax credit and disclosure, footnote or otherwise, is not essential reporting procedure.

Special Treatment of Foreign Assets and Liabilities in the Consolidated Balance Sheet

In the preceding section various techniques relating to the treatment in consolidated financial statements of unremitted foreign subsidiary earnings

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[35]American Institute of Accountants - Research Department, "Some Problems Regarding Consolidated and Parent Company Statements", Journal of Accountancy, November, 1953, p. 57.

were examined. The second major problem area in connection with the inclusion of the accounts of foreign subsidiaries in consolidated financial statements pertains to the disclosure of the amount and nature of foreign assets and liabilities included in the consolidated balance sheet. As has been previously pointed out, the alternative techniques which may be employed in this connection actually represent the implementation of a range of opinions as to the degree of consolidation which is considered to be appropriate.

At one extreme in terms of the degree to which assets and liabilities of foreign subsidiaries may be included in consolidated statements is complete exclusion of foreign subsidiary accounts from consolidation. In this situation the only effect of foreign holdings on the consolidated balance sheet is the inclusion of the cost of the investment in foreign affiliates. Quite apparently, in this situation, there is no real problem of special consolidated balance sheet disclosure of foreign assets and liabilities, but it is not uncommon for the financial data presented in the annual report to stockholders of the parent corporation to include, in more or less detail, information relative to the underlying book value of foreign assets and liabilities and to the equity of the parent company therein. International Harvester Company does not consolidate any subsidiary companies in the financial statements in its annual report, but presents a tabulation which sets forth the parent company's equity in subsidiary net assets at their nearest fiscal year closing in comparison with the cost of the related investment. This tabulation was presented on page 232 in connection with the discussion of the reporting of foreign subsidiary earnings. Burroughs Adding Machine Company presented the following combined statement of financial condition of subsidiary companies operating in other countries in its 1950 annual report. The investment in foreign subsidiaries

was stated at cost in the December 31, 1950 consolidated balance sheet.

Statement of Financial Condition

	December 31 1950	December 31 1949
Working Capital:		
Cash	$ 2,685,283	$ 2,074,331
Foreign government securities	20,287	20,619
Amounts receivable from customers and others, less estimated amounts which may not be collected	3,906,754	2,617,488
Inventories of purchased materials and finished and partly finished products	8,865,140	6,535,863
Expenses paid in advance	152,486	120,694
Current assets	$15,629,950	$11,368,995
Current liabilities, including amounts owing to parent company	11,140,988	7,135,353
Working capital	$ 4,488,962	$ 4,233,642
Cost of Land, Buildings and Equipment	3,064,314	2,508,371
Less estimated cost of wear and exhaustion (depreciation)	(1,028,216)	(813,567)
Other Assets	386,109	249,066
Mortgage Loan Payable	(86,508)	(91,205)
Net assets owned by parent company	$ 6,824,661	$ 6,086,307 [36]

The preceding examples indicate possible alternative procedures for the presentation of the amount and classification of foreign assets and liabilities in situations in which the accounts of foreign subsidiaries are not consolidated (in the usual sense of the word) with those of the parent corporation.

At the other extreme, in terms of the degree to which the asset and liability accounts of foreign subsidiaries may be included in a consolidated balance sheet, is complete or full consolidation. This procedure would result in the merging of all foreign asset and liability items with related domestic classifications in the consolidated balance sheet. Under these circumstances disclosure of the amount and type of foreign assets and liabilities may be made by means of a footnote appended to the consolidated balance sheet or by the presentation of supplementary tabulations setting

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[36] Burroughs Adding Machine Company, Annual Report (1950), p. 27.

forth the details of foreign assets and liabilities included in the consolidated balance sheet.

The following note, appended to the December 31, 1952 consolidated balance sheet of Parke, Davis & Company, illustrates the use of the footnote disclosure procedure:

> The net assets in foreign countries included in the accompanying balance sheet amount to approximately $17,570,000, including net current assets of $10,510,000.[37]

More detailed footnote disclosure of foreign assets and liabilities included in a consolidated balance sheet is illustrated by the following note included in the 1952 annual report of Coca-Cola Company.

> The accounts of subsidiaries and branches operating in foreign countries, consolidated in this balance sheet, consist of: current assets, $28,006,067.42 (including cash and government securities aggregating $12,664,248.61); property, plant, and equipment at depreciated cost, $18,289,560.96; other assets, $5,219,676.62; and liabilities, $17,553,175.96.[38]

Disclosure of foreign assets and liabilities included in consolidated balance sheet totals by means of supplementary tabulations may be illustrated by the following schedule included in the 1952 annual report of Standard Oil Company (New Jersey). It should be emphasized that Standard Oil Company included the accounts of affiliates located in the United States and in other Western Hemisphere countries in appropriate balance sheet classifications but carried the investment in European and North African subsidiaries at cost or less in an investment classification in the consolidated balance sheet.

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[37] Parke, Davis & Company, op. cit., p. 12.

[38] Coca-Cola Company, op. cit., p. 6.

STANDARD OIL COMPANY (NEW JERSEY)
Net Assets and Earnings - Geographically

The approximate geographical distribution of the consolidated net assets included in the consolidated statement of financial position as of December 31, 1952 . . . is as follows:

	United States	Other Western Hemisphere	Europe and North Africa	Middle and Far East	Total
Current assets:					
Cash					
Marketable securities					
Other current assets					
Current liabilities					
Working capital					
Investment in companies, owned over 50%, in Europe and North Africa					
Other investments					
Property, plant, and equipment, less depreciation, etc.					
Other assets					
Deduct:					
Long-term debt and reserves					
Minority interests					
Reserve for possible losses on foreign investments					
Net assets which correspond to shareholders' equity shown in the consolidated statement of financial position[39]					

An interesting technique of disclosing the amounts of foreign assets and liabilities included in consolidated balance sheet totals is employed by Twentieth Century-Fox Film Corporation. The consolidated balance sheet is entitled "Consolidated Balance Sheet and Memorandum of Foreign Assets and Liabilities" and is presented with two separate columns, in the following form:

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[39]Standard Oil Company (New Jersey), Annual Report (1952), p. 22.

Consolidated	Foreign (Included in Consolidated)[40]

The first column presents balance sheet amounts giving effect to complete consolidation of foreign assets and liabilities and the second column indicates the amounts of each type of foreign asset or liability which is included in the related consolidated total. Paramount Pictures Corporation employed a somewhat similar presentation for several years, utilizing the following columns in the principal balance sheet included in its annual report.[41]

Total	U.S.A. and Canadian Companies	Other Foreign Companies

The "Total" column presents consolidated totals including the assets and liabilities of foreign subsidiaries, and the other two columns show the geographical location of the amounts included in the consolidated totals.

The preceding section has been concerned with an examination of possible methods of disclosing the magnitude and nature of the assets and liabilities of foreign affiliates in circumstances in which the accounts thereof are fully consolidated with related assets and liabilities of the domestic parent corporation and in the situation in which there is no consolidation of the asset and liability accounts of foreign subsidiaries. As might be expected, the more interesting reporting procedures occur in situations in which what may be characterized as partial consolidation of the balance sheets of domestic and foreign corporations is employed. Partial balance sheet consolidation methods may be classified into three categories according to the extent to which full or complete consolidation is approached.

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[40] Twentieth Century-Fox Film Corporation, Annual Report (1952), pp. 14-15.

[41] Paramount Pictures Corporation, Annual Report (1944), pp. 4-5.

The discussion and illustrations presented below will follow this three way classification.

The first level of partial consolidation which may be employed involves presenting the net assets of foreign subsidiaries in a single amount on the consolidated balance sheet. Typically, this result is produced by carrying the account representing the investment in foreign subsidiaries at an amount equal to the parent company's equity in the net assets of foreign affiliates, and presenting the resulting amount on the consolidated balance sheet in an investment classification. It is rather common, when this procedure is employed, to present a supporting tabulation setting forth the details, in terms of specific assets and liabilities, of the amount shown as a single figure on the consolidated balance sheet. Burroughs Adding Machine Company has employed this procedure in the financial statements included in its 1951 and 1952 annual reports. The December 31, 1952 consolidated balance sheet includes the following item, presented below the determination of net current assets.

	December 31, 1952	1951
INVESTMENTS in and advances to subsidiary companies operating outside the United States and Canada, at equity in net assets	9,860,828	8,298,383[42]

A statement is included in the annual report to present the details of the amounts carried in the investment category. This statement is essentially the same as that presented on page 255. The final amounts in this statement, described as "Parent company's equity in net assets", agree with the amounts shown in the investment category.

Armour and Company follows essentially the same procedure as Burroughs in relation to the consolidated balance sheet included in its annual report, presenting in an investment classification the investment

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[42]Burroughs Adding Machine Company, Annual Report (1952), p. 20.

in capital stocks of foreign subsidiaries stated at equity in net worth less parent company reserves related thereto. This single amount is detailed in a supporting schedule which also divides foreign assets and liabilities as to geographical location.

National Cash Register Company carries the investment in foreign subsidiaries on its consolidated balance sheet at equity in net asset value less an amount equal to the unremitted earnings of foreign affiliates. A geographical balance sheet in the following form is included to provide more detailed information regarding foreign net assets.

	Canada	Great Britain and Commonwealth	Central & South America	Continental Europe	Other	Total November 30, 1952	1951
Current assets							
Current liabilities							
Working capital							
Properties							
Other assets							
Total							
Less:							
Mortgage payable							
Reserves							
Net assets							
Less:							
Minority interest							
Unremitted profits[43]							

The amount which appears on the last line of the total column of the preceding schedule is equal to the single figure presented on the consolidated balance sheet.

It is interesting to observe that even though the three companies cited above (Burroughs, Armour, and National Cash Register) employ essentially similar procedure in terms of presenting foreign net assets on the consoli-

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[43]National Cash Register Company, Annual Report (1952), p. 19.

dated balance sheet, their procedure in relation to the recognition of foreign earnings differs considerably. Burroughs and National Cash Register combine foreign and domestic revenues and expenses in the consolidated income statement and deduct, in this statement, an amount representing foreign earnings not remitted to the United States. Burroughs presents the accumulated unremitted foreign profits as a part of consolidated net worth, while National Cash Register, as indicated above, treats unremitted foreign earnings as a deduction from foreign net assets. Armour reports only dividends received from foreign affiliates in the consolidated income statement, considering the amount representing unremitted foreign earnings to be a part of consolidated paid-in surplus.

The second level of consolidation of foreign assets and liabilities involves the presentation in the consolidated balance sheet of some degree of detail as to the form of foreign net assets, but, unlike normal consolidation procedure, this information is presented in a special non-current balance sheet classification. The following section of the December 31, 1952 balance sheet of The Gillette Company illustrates this technique.

INVESTMENT IN FOREIGN COUNTRIES OTHER THAN CANADA REPRESENTED BY ASSETS AND RELATED LIABILITIES AND PROVISION FOR POSSIBLE LOSSES AS FOLLOWS:		
IN OTHER THAN GERMANY:		
Current assets	$19,825,037	
Current liabilities	6,211,740	13,613,297
Fixed assets-net		6,973,183
Other assets		260,863
		20,847,343
Accrued foreign income taxes payable in 1954		5,282,816
		15,564,527
IN GERMANY - Net investments in subsidiary companies not consolidated (at cost after elimination of goodwill)		1,187,356
		16,751,883
PROVISION FOR POSSIBLE LOSSES IN FOREIGN INVESTMENTS		2,500,000
		14,251,883[44]

[44]The Gillette Company, op. cit., p. 14.

The third type of partial consolidation of the balance sheet accounts of foreign subsidiaries results in foreign assets and liabilities being presented in the appropriate section of the consolidated balance sheet (current assets, current liabilities, etc.), but, rather than individual asset and liability items being merged with related domestic items, a single amount representing the appropriate foreign total of the particular balance sheet classification is shown. This technique is employed by Sharp & Dohme, Incorporated in its December 31, 1952 balance sheet, which is presented below:

SHARP & DOHME, INCORPORATED and SUBSIDIARY COMPANIES
Consolidated Balance Sheet
December 31, 1952

ASSETS

Current assets:	
Cash	$ 6,391,879.99
Notes and accounts receivable-net	5,327,246.87
Inventories	13,387,953.23
Current assets of foreign subsidiaries and branches	5,542,687.43
Total current assets	$30,649,767.52
Investment in affiliated company, at cost	5,000.00
Fixed property, at cost-net	14,411,319.04
Trade-marks, patents, copyrights, etc.	2.00
Prepaid and deferred accounts	199,780.55
Other assets of foreign subsidiaries and branches	804,694.01
	$46,070,563.12

LIABILITIES

Current liabilities:	
Notes payable-bank	$ 225,000.00
Accounts payable	1,027,332.02
Accruals	3,104,519.32
Current liabilities of foreign subsidiaries and branches	2,323,166.26
Total current liabilities	$ 6,680,017.60
Long-term debt	5,000,000.00
	$11,680,017.60

CAPITAL

Capital stock-preferred and common	14,825,627.39
Reserve for contingencies	1,000,000.00
Earned surplus (including $1,498,525.62 undistributed earnings of foreign subsidiaries and branches)	18,564,918.13
	$46,070,563.12[45]

[45] Sharp & Dohme, Incorporated, Annual Report (1952), pp. 24-5.

It will be noted that the total current assets and total current liabilities of foreign subsidiaries and branches are presented in single amounts as the last items in the current asset and liability sections of the consolidated balance sheet, and that a separate non-current asset category is employed to present, as a single amount, the non-current foreign assets. The amount of undistributed earnings of foreign subsidiaries and branches is parenthetically noted in connection with earned surplus. It is apparent that this procedure represents the closest possible approach to complete consolidation of balance sheet accounts which still gives formal recognition, in the consolidated balance sheet, to the amounts and types of foreign assets and liabilities. Its use will result in balance sheet subtotals which will cause the same results to emerge from typical analytical calculations as would be produced from a balance sheet reflecting complete consolidation.

Consolidated Balance Sheet Classification of Restricted Foreign Cash

A problem which, at least at first glance, appears to be closely related to that of giving special treatment or disclosure in consolidated financial statements to foreign assets and liabilities arises in situations in which the assets of a foreign subsidiary include a substantial amount of cash in excess of normal business requirements which cannot be transmitted to the parent corporation because of limited convertibility of the foreign currency. In the preceding chapter various examples of limited convertibility which might give rise to this situation were presented. Actually this problem is not created by a desire to give special disclosure to foreign assets, but rather emerges as the result of the observation of generally employed criteria as to what items should be included in current assets. Is it proper, in a situation in which complete consolidation of the balance sheet accounts of foreign subsidiaries is contemplated, to include restricted

foreign cash in excess of current operating needs in consolidated current assets? In order to answer this question it is necessary to examine the criteria governing the inclusion of an asset element in the current classification. The following statements are taken from the recommendations of the Committee on Accounting Procedure of the American Institute of Accountants.

> 4. For accounting purposes, the term current assets is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. Thus the term comprehends in general such resources as (a) cash available for current operations and items which are the equivalent of cash...
>
> 6. This concept of the nature of current assets contemplates the exclusion from that classification of such resources as: (a) cash and claims to cash which are restricted as to withdrawal or use for other than current operations.....[46]

The conclusions of the Bulletin from which the preceding statement was taken were endorsed by the Committee on Concepts and Standards Underlying Corporate Financial Statements of the American Accounting Association in Supplementary Statement No. 3 issued by that committee.

It is now necessary to reach a conclusion as to how cash in foreign countries in excess of local operating needs but not remittable because of exchange restrictions fits into the concept of current assets set forth above. There is little question but what excess restricted foreign cash is "available for current operations" and that, from the point of view of the foreign subsidiary such cash is not "restricted as to withdrawal or use for other than current operations." This would seem to lead to the conclusion that restricted foreign cash is properly includible in current assets on the consolidated balance sheet. However, when we depart from the letter of the concept of current assets previously examined and consider the underlying considerations motivating the development of such a concept, a different

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[46] American Institute of Accountants - Committee on Accounting Procedure, Bulletin Number Forty Three - Restatement and Revision of Accounting Research Bulletins (1953), pp. 20-21.

conclusion would seem to be merited. From a broader point of view the current asset classification on a statement of financial position is intended to measure the value, in terms of approximate cash realizable amount, of the resources of the enterprise which are not only available for current operating purposes but which will, in fact, be so used. Restricted excess foreign cash, although certainly in a form which would normally justify inclusion in the current asset group, will not, in the foreseeable future be used in the operations of the foreign affiliate. In addition, convertibility restrictions may effectively prevent transfer of excess foreign cash to the parent corporation for its use. From this point of view excess restricted foreign cash is no more a proper component of consolidated current assets than segregated asset funds or other clearly non-current items. In fact, there would be considerably greater theoretical merit in considering the portion of tangible fixed assets which will be consumed during the next operating cycle as properly includible in the current asset group than in reflecting excess cash in this category. It should be emphasized that we are not concerned with foreign cash balances which may be characterized as excessive as a result of seasonality in the operating characteristics of the foreign affiliate, but rather with cash balances in excess of the amount required in the operations of the foreign enterprise in the foreseeable future.

Having concluded that the exclusion of restricted foreign cash in excess of operating requirements from consolidated current assets represents proper reporting procedures, there still remains the problem of calculating the amount of restricted foreign cash which may be said to be "excessive" in relation to current operating requirements. Quite apparently this is not a problem to which a general solution applicable to all types of foreign operations can be formulated. Rather it is necessary to consider the

characteristics of a particular situation in regard to the current cash requirements, as well as expected expansion or contraction in the scale of operations, and any other future events which may be expected to influence future cash requirements. The amount of the balance sheet date cash balance in excess of expected cash requirements computed in this manner represents the amount which should be excluded from consolidated current assets. An alternative procedure which may be conveniently applied would be to estimate the amount of the cash dividend which would be declared and remitted to the parent corporation if no restrictions on the convertibility of the foreign currency for this purpose existed. This decision would presumably reflect the considerations indicated above in connection with the computation of the necessary cash balance, and, hence, is not a completely separate procedure. Regardless of the procedure employed it should be recognized that any conclusion which results from an evaluation of the factors just mentioned must be considered to be an intelligently determined approximation, not a precisely determined amount.

An example of non-current classification of restricted foreign cash in excess of operating requirements may be found in the consolidated balance sheet of General Motors Corporation. The following item is presented as one component of a "Miscellaneous Assets" classification:

	Dec. 31, 1952	Dec. 31, 1951
Cash in foreign countries in excess of operating needs, subject to exchange restrictions	20,916,393	24,365,685[47]

It will be recalled that The Gillette Company, in the note in its annual report presented on page 239 of this chapter, indicated the amount of foreign retained earnings which was in excess of current requirements, but with no indication of the form of the foreign assets to which this excess related.

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[47]General Motors Corporation, Annual Report (1952), p. 44.

In this case there was no problem of non-current classification of excessive foreign cash since all foreign assets were included in a non-current classification in the consolidated balance sheet.

Summary

The present chapter has been divided into two sections, the first of which examined the factors to be considered in regard to the inclusion of the accounts of foreign subsidiary corporations in consolidated financial statements, and the second considered and illustrated various reporting techniques aimed at special financial statement treatment of unremitted foreign earnings and foreign assets and liabilities.

It was the conclusion of the first section that the two fundamental criteria relative to the inclusion of the accounts of a foreign subsidiary in consolidated statements are effective control of the subsidiary and a reasonably close degree of relationship between the type of operations conducted by the parent and subsidiary corporations. Geographical location and the existence of foreign exchange controls of various types are not, in themselves, fundamental considerations in regard to consolidation. These factors may be quite important, however, insofar as they may operate to limit materially the effective control of the affairs of the subsidiary by the parent corporation. It was concluded that, in the general case, the accounts of a foreign subsidiary should be included in consolidated statements in situations in which effective control and homogeneity of operations exist, but that careful consideration must be given in each case to the effect on these two criteria of exchange and other forms of foreign government controls. In specific circumstances the effect of these forms of controls may be such as to render consolidation inappropriate, but the mere existence of controls must not, per se, be considered to be sufficient to justify exclusion of foreign accounts from consolidated statements.

The second section of this chapter examined various methods which have been employed to accord special consolidated statement treatment to foreign earnings and net assets. It was concluded that these procedures actually constitute the implementation of a range of decisions as to the degree of consolidation of foreign data which is considered to be appropriate in a particular situation. In relation to the consolidated income statement, the degree of consolidation may range from complete consolidation of foreign operating results to recognition of foreign earnings only when received in dividends. The most prevalent current procedure occupies a middle ground and involves combining foreign and domestic revenues and expenses and deducting, in the process of arriving at consolidated net income, an amount representing unremitted foreign earnings. This procedure requires the introduction into the consolidated balance sheet of an account representing foreign retained earnings which may be classified in a reserve category, presented as a designated part of consolidated net worth, or deducted from foreign net assets.

Disclosure of foreign net assets included in the consolidated balance sheet may be accomplished by the use of supplementary tabulations in a situation in which the formal consolidated balance sheet reflects full consolidation, or by identification of foreign net assets in the consolidated balance sheet. The latter technique may involve the presentation of foreign net assets in a single amount or in some detail in a non-current section of the consolidated balance sheet or the presentation of foreign assets and liabilities in single amounts in the appropriate balance sheet categories. A related problem may arise in regard to the proper consolidated balance sheet classification, in a situation in which full consolidation is carried out, of restricted foreign cash in excess of operating needs. It was concluded that the amount of excess restricted foreign cash should be presented

in a non-current asset classification on the consolidated balance sheet. The determination of the amount of excess cash is a problem which must be solved in each case, giving recognition to the expected cash requirements of the particular enterprise.

CHAPTER VI

SUMMARY AND CONCLUSIONS

It has been the objective of the preceding chapters to examine the major problem areas related to the reporting of foreign operations. It is now appropriate to summarize the most significant conclusions which have been formed as a result of this examination.

Translation of Foreign Currency Accounts into Dollars

The problem of expressing foreign currency accounts in dollars is similar in many respects to the problem of adjusting dollar accounts to give recognition to altered economic significance of the dollar caused by changes in the general price level or in the level of specific prices. In both situations the objective is to achieve homogeneity in the units which are employed to measure the results of business operations and the resulting financial position. The procedures which have been recommended in this discussion as being productive of the most rational results in connection with the translation of foreign currency accounts into dollars are the result of the application of the same fundamental principles which may be employed to achieve dollar financial statements expressed in terms of homogeneous dollars.

The most important conclusion which emerged from the examination of the problem of translating foreign asset, liability, and net worth accounts into dollars related to the classification of balance sheet accounts in connection with the exchange rate (present or historical) which should be employed in the translation process. It is conventional procedure to translate current asset and current liability accounts by use of the exchange rate in effect on the date of the translation, applying historical rates (acquisition or incurrence date) to non-current assets and liabilities. It was the

conclusion of this inquiry that more appropriate dollar amounts result from dividing asset and liability elements into those which are expressed in terms of a contractually determined number of foreign currency units as distinct from those which do not possess a directly determinable foreign currency value. The translation date rate should be applied to asset and liability items in the money-value category, with non-money-value assets being translated by use of the acquisition date exchange rate. The principal effect of this recommendation, in contrast with conventional technique, is to remove inventory items from the current rate category and to require translation of long-term receivables and payables at the translation date (current) rate. The use of this technique will produce dollar values for foreign currency assets and liabilities which are much more satisfactory in terms of traditional asset and liability valuation concepts than those which emerge from the use of conventional translation procedures.

It was concluded in connection with the translation of foreign currency revenue and expense balances that, ideally, the effect of each revenue and expense transaction should be expressed in dollars in terms of the exchange rate in effect on the date when the transaction occurred. In the interests of practicality, however, the use of month-end rates for the translation of revenue and expense totals for each month of the fiscal period was suggested as being productive of acceptably accurate results. The use of a single average rate for the entire operating period or, in particular, the use of the closing date rate was condemned. It was maintained that one of the important criteria governing the selection of an acceptable procedure for the translation of operating accounts should be the effect of the procedure on the determination of the net income or loss resulting from ordinary manufacturing or merchandising activities as distinct from the gain or loss resulting from changes in the dollar value of the foreign

currency during the operating period in question. Only the use of daily or, as an expedient alternative, month-end rates will achieve this result in a reasonably accurate fashion. The gain or loss on exchange rate movements should, and with the use of the translation procedures recommended in this discussion will, be measured by the change in dollar value of foreign net money-value assets. This gain or loss should be considered to be a part of the over-all operating results of the foreign affiliate but satisfactory evaluation of the performance of the management of the subsidiary requires that the exchange gain or loss be computed in a reasonably accurate manner and reported separately from manufacturing or merchandising profit or loss.

The Impact of Exchange Controls

The wide variety of purposes and resulting forms of government control of the international receipts and payments process were examined and illustrated as a preliminary to investigating the impact of such controls on the reporting of foreign operations. It was concluded that the existence of restrictions on the convertibility of a foreign currency has no necessary general effect on the reporting of foreign operations. This is particularly true if the restrictions are entirely or at least principally related to the remittance of foreign capital. Restrictions on the convertibility of the foreign currency for the purpose of transmitting earnings must be examined more carefully in regard to their effect on the reporting of foreign operations. There is no reason to consider that the existence of restrictions on the remittance of current earnings should render the translation of foreign currency accounts into dollars inappropriate. It was concluded that the major issue which is raised by the existence of blocked foreign earnings relates to the recognition of such unremitted earnings in the accounts of the parent corporation. In this connection it was concluded that the specific form of exchange restriction together with the real effect

of the existence of restricted convertibility in each case must be considered as a necessary part of reaching a decision as to parent company recognition of restricted unremitted earnings. It was emphasized that the existence of limited convertibility does not, per se, create conditions which render the recognition of unremitted foreign earnings by a parent corporation inappropriate. Only if the real effect of such restrictions is such as to hamper substantially the freedom of parent company action in regard to the administration of foreign earnings does the existence of restrictions necessitate exclusion of unremitted foreign earnings from the records of the domestic parent company.

It is not uncommon at the present time to find situations in which a particular country employs a multiple exchange rate procedure, with different rates being applicable to the purchase or sale of foreign exchange for particular purposes. This situation creates a problem of choosing the appropriate rate to use in connection with the translation of foreign currency balances into dollars. It was concluded that the appropriate rate to employ for this purpose is the rate which is specified as being applicable to financial remittances, e.g., dividends. It was also concluded that it was desirable to apply the rate which is selected to all foreign account balances.

Effect of Devaluation of a Foreign Currency

It was concluded that a substantial decrease in the external value of a foreign currency resulting from governmental decree rather than free market forces should be considered to represent, from the point of view of other countries, the adoption by the devaluing country of a new currency unit. It follows from this conclusion that the pre-devaluation rates will no longer be employed in connection with the translation of foreign currency accounts into dollars. A possible exception to this principle would exist in connection with the translation of foreign revenues and expenses for the

pre-devaluation date portion of the operating period during which the devaluation occurred. The immediate post-devaluation date rate would be substituted for historical acquisition date rates in the translation of non-money-value assets into dollars.

The translation of revenue and expense accounts for the operating period during which the devaluation occurred should be accomplished through the use of the same techniques which would have been employed had the devaluation not occurred. This will result in the application of pre-devaluation rates to the revenues earned and expenses incurred before the date of the devaluation and the application of post-devaluation rates to revenues and expenses recorded after the date of the devaluation.

The loss resulting from the reduced dollar value of the foreign currency caused by the devaluation should be measured by the decline in the dollar value of the net assets of the foreign subsidiary caused by the change from pre-devaluation to post-devaluation exchange rates in the translation of foreign currency balances. This loss should be assigned to the foreign subsidiary, but the decision as to income statement as opposed to retained earnings charge in connection with this loss would be governed by the materiality of the loss in relation to the net income of the foreign subsidiary for the period during which the devaluation occurred.

Inclusion of the Accounts of Foreign Subsidiaries in Consolidated Financial Statements

It was concluded that consolidated financial statements should be considered to be distinctly supplementary to the financial statements of the separate legal entities involved in the inter-corporate affiliation. This conclusion was reinforced by an examination of the persons or groups who may secure valuable financial data from consolidated statements. This inquiry resulted in the conclusion that the management of and investors in

the parent or holding company are the only groups which can benefit greatly by the data reflected by consolidated statements.

Given the supplementary position occupied by consolidated statements, it would seem to be appropriate to include the accounts of foreign subsidiaries in such statements so long as the basic criteria applied to the problem of consolidation at the domestic corporation level are still substantially satisfied by the circumstances surrounding a foreign subsidiary. These basic criteria were stated to be effective control and a reasonable degree of homogeneity in regard to the operating characteristics of the parent and subsidiary corporations. Only if the existence of exchange controls, such as limited convertibility, operate to impair the normal degree of effective control of the policies of the subsidiary by the parent would elimination of the foreign subsidiary's accounts from consolidated statements be desirable. There is evidence that the existence of controls, per se, has been accepted as sufficient reason for excluding the accounts of a foreign affiliate from consolidated statements. Only if exchange or other foreign government controls actually impair the normal freedom of parent company control of the affairs of the subsidiary is such exclusion justified. It is apparent that this is a decision which must be made in recognition of the specific conditions of each particular case, in view of such matters as the specific form of exchange control, the need for retention of earnings within the foreign subsidiary, etc. It would seem to be reasonable to conclude that, in the general case, consolidation of foreign subsidiaries is appropriate, and that exclusion from consolidation requires evidence in justification of such procedure.

As a result of excessive regard for the effect of exchange controls, a number of hybrid consolidation techniques have come to be used in the published financial reports of American corporations. These procedures were

examined and illustrated with particular regard for the effect of their use on the inclusion of unremitted foreign earnings in the consolidated income statement as well as the segregation or special disclosure of foreign net assets in the consolidated balance sheet.

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