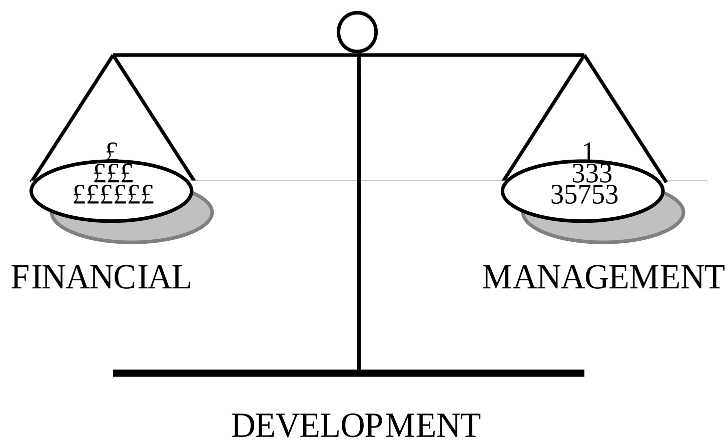
FINANCIAL MANAGEMENT DEVELOPMENT

Financial Accounting

Common Problem Areas

NO 142

ACCOUNTING FOR FOREIGN EXCHANGE DIFFERENCES



ONE OF A SERIES OF GUIDES FOR

FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

ACCOUNTING FOR FOREIGN EXCHANGE DIFFERENCES

WHY DO FOREIGN EXCHANGE DIFFERENCES ARISE?

Foreign exchange differences would not arise if:

1. All transactions were carried out in the same currency or
2. All transactions were recorded on a cash (i.e. not accruals) basis or
3. The rates of exchange between currencies were fixed or
4. The future rates of exchange were known in advance.

Foreign exchange differences arise because companies record transactions on an accruals basis but do not know the value of the transaction in their local currency. Companies can avoid the problem of foreign exchange differences by:

1. Only dealing in one currency
2. Only recording foreign currency transactions when they are converted into local currency in cash
3. Fixing the rate of exchange to be used.

However, for most companies dealing in purchases or sales overseas these options are not available and it is therefore inevitable that differences will arise between the local currency amount at which transactions are recorded and the amount at which they are finally completed.

WHAT IS THE PROBLEM?

Assume a UK company agrees to sell 100 items to a U.S. company at $16 each. The items cost £6 each to make. The exchange rate when the sale is recorded (on shipment) is £1 = $1.60. The UK company records show:

	£
Sales	1,000
Costs	600
Profit	400

and the Balance Sheet shows a debtor of £1,000.

The customer pays one month later when the rate is £1 = $2.00 and the company receives £800. It has therefore lost £200, not from trading, but from the decision to hold a dollar asset (the debt) while the value of the dollar decreased. In order to avoid corrupting their <u>trading</u> results many companies show these differences as a separate profit and loss item.

In practice the problem arises even where the asset (or liability) has not been turned into cash. Thus if the debt remained unpaid the company would still show the debt in the accounts at the end of the month as having fallen in value.

HOW DO COMPANIES ACCOUNT FOR THE DIFFERENCES?

The treatment of differences varies but the most common approach in published accounts is as follows -

1. All assets and liabilities are translated into local currency at the rate of exchange prevailing at the Balance Sheet Date. Any differences between these amounts and those previously recorded are treated as “movements on reserves” i.e. the value of shareholder’s funds changes but this is not shown in the Profit and Loss Account.

2. Foreign earnings (i.e. net income) are included at the average rate for the accounting period. Differences between these figures and the year end rate are taken direct to reserves.

3. Other differences including those on foreign currency conversion are included in the Profit and Loss Account - separately identified if material.

4. Transactions in hyper inflationary currencies are adjusted for if appropriate.

In management accounts the ultimate results will adopt the above approach but many organisations use fixed rates (annually, quarterly or monthly) to avoid distorting budget or prior period comparisons in the trading account. The differences are then accounted for as a separate line item. Whilst this assists review it can lead to misleading information for decision making purposes. Any organisation which uses fixed rates should ensure that the rates are reasonably close to reality or carry out calculations to check that the decisions are still valid after exchange differences have been allowed for. Thus in the earlier example a decision to sell at $10 per item would show an apparent profit of £25 using $1.60 as the exchange rate but in fact would result in a loss of £100 at a rate of £1 =$2.

Note that in many multinational organisations the central treasury function will manage the cash flows and many organisations protect their trading subsidiaries from the effects of exchange movements but placing the onus on the Treasury department, thus allowing the differences to surface in their management data. This allows them to review the impact and take tactical and strategic decisions on which currencies to be "long or short in" i.e. hold or not. It then becomes easier to value the benefits of taking forward foreign exchange contracts (straight purchase, caps, collars etc.) to remove or reduce the risk of loss - although the temptation to "make gains" from this activity has caused impressive losses in the past. It is wise to remember the business you are in..."Lead us not into temptation" is a good motto for Treasury managers.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website: **FinancialManagementDevelopment.com** including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

