

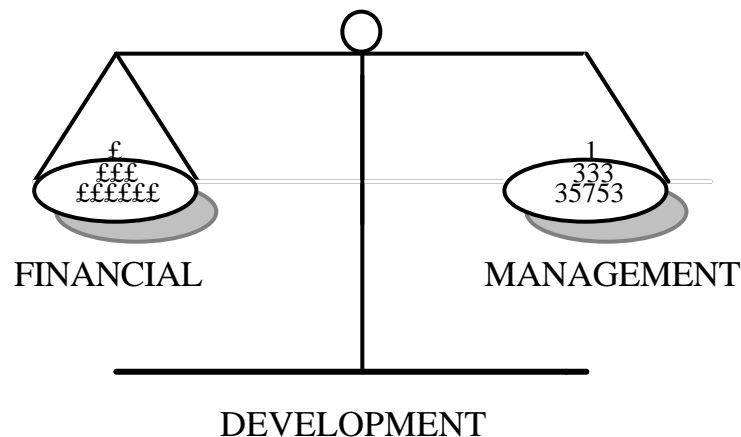
# FINANCIAL MANAGEMENT DEVELOPMENT

## 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	<u>600</u>
Profit	<u><u>400</u></u>

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 trading 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.

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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.

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 thirty major organisations including Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, The Post Office, Rothmans and Zeneca. International training experience includes work in Denmark, Kenya and the Czech Republic for Unilever, in Dubai for Al Atheer, in Holland and the U.S. for Avecia and Zeneca and in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. A key output from the training is demonstrable use of the knowledge and skills acquired to enhance corporate profitability. In addition he has run courses in acquisition evaluation (The Economist, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). He has also developed material for delivery by in house personnel (Royal Mail, Lloyds Bowmaker and Conoco) and computer based training packages (The Post Office, Unilever and BP).

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 and the need for taxation awareness training for general managers.

He is married with one grown up daughter and his outside interests include being The Treasurer of the Hospice of St. Francis (Berkhamsted), and a member of the Catholic Alpha Training Team (Promoting the Alpha course on Basic Christianity). He was a Governor of Luton University for nine years and a school Governor for four years.

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).