Case 7

Palmerstown Company

Palmerstown Company established a subsidiary in a foreign country on January 1, Year 1, by investing 8,000,000 pounds when the exchange rate was $1.00/pound. Palmerstown negotiated a bank loan of 4,000,000 pounds on January 5, Year 1, and purchased plant and equipment in the amount of 10,000,000 pounds on January 8, Year 1. Plant and equipment is depreciated on a straight-line basis over a 10-year useful life. The first purchase of inventory in the amount of 1,000,000 pounds was made on January 10, Year 1. Additional inventory of 12,000,000 pounds was acquired at three points in time during the year at an average exchange rate of $0.86/pound. Inventory on hand at year-end was acquired when the exchange rate was $0.83/pound. The first-in, first-out (FIFO) method is used to determine cost of goods sold. Additional exchange rates for the pound during Year 1 are as follows:

January 1–31, Year 1	$1.00
Average for Year 1	0.90
December 31, Year 1	0.80

The foreign subsidiary's income statement for Year 1 and balance sheet at December 31, Year 1, are as follows:

INCOME STATEMENT
For the Year Ended December 31, Year 1

	Pounds (in thousands)
Sales	15,000
Cost of goods sold	9,000
Gross profit	6,000
Selling and administrative expenses	3,000
Depreciation expense	1,000
Income before tax	2,000
Income taxes	600
Net income	1,400
Retained earnings, 1/1/Y1	0
Retained earnings, 12/31/Y1	1,400

BALANCE SHEET
At December 31, Year 1

	Pounds (in thousands)
Cash	2,400
Inventory	4,000
Property, plant, and equipment	10,000
Less: Accumulated depreciation	(1,000)
Total assets	15,400
Current liabilities	2,000
Long-term debt	4,000
Contributed capital	8,000
Retained earnings	1,400
Total liabilities and stockholders' equity	15,400

As the controller for Palmerstown Company, you have evaluated the characteristics of the foreign subsidiary to determine that the pound is the subsidiary's functional currency.