

Foreign Currency Transactions

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Foreign Currency Transactions

- Most sovereign countries have their own currencies, and (when doing business internationally) will enter into transactions in either the foreign or the domestic currency
- The **currency** in which transactions are denominated is **an aspect of the transaction which is as important as the negotiated price**
- Strong and stable currencies, such as the US dollar (USD), the Swiss franc (CHF) or the Euro (EUR) €, are frequently specified for international transactions

Foreign Currency Transactions

- Canadian companies have no particular advantage when dealing internationally, and must frequently accept that international transactions are to be denominated in a foreign currency rather than Canadian
 - these foreign currency transactions must be recorded in the reporting currency of the company
 - The assets and liabilities denominated in the foreign currency must be repaid in that currency, so the Canadian company will bear the risks and costs associated with the inevitable currency fluctuations

Foreign Currency Transactions

- Why do currency fluctuations occur?
 - Currency exchange rates are the price of a currency, denominated in another currency
 - Like all prices, currency exchange rates are a function of supply and demand
 - As with the determination of the price of a share in the stock market, the amounts that traders are willing to bid or ask for a currency are indicative of not only current supply and demand, but expectations as to future events
 - As economic conditions evolve, and expectations change, inevitably, fluctuations will occur

Foreign Currency Transactions

- Currency fluctuations are relevant to companies and to users of their financial statements
 - At each statement date
 - monetary amounts are restated to the current exchange rate
 - Foreign currency gains and losses on current items must be recorded and reported in the period in which they occur
 - Although once subject to deferral and amortization, gains and losses arising on non-current items are now subject to immediate recognition in the period

Foreign currency transactions

- Canadian standards, until 2001, required the deferral and amortization of foreign currency gains and losses on non-current items
 - This treatment was unique to Canadian practice
 - The allocation was based on the matching principle in that the currency gain or loss relates to the period which benefits from the monetary item
 - Nearly all other countries require immediate recognition of the income effect
- Although no longer required for businesses, the same provisions have been proposed for the CICA Public Sector Accounting Handbook

Foreign Currency Transactions

- How does accounting for foreign currency transactions work?
 - When the transaction is initially entered, the amounts are recorded in the reporting currency of the companies entering into the transaction
 - At each statement date, the foreign currency amount is restated to the reporting currency equivalent, and a gain or loss is recognized
 - At the time of settlement of the asset or liability, the amount is again restated to the reporting currency equivalent, and a further gain or loss is recognized

Foreign Currency Transactions

- Accounting for a foreign currency transaction is illustrated using the following rates:

<u>Date</u>	<u>Rate (US\$ / C\$)</u>
Jan 31	1.53
Feb 28	1.55
Mar 30	1.56

Foreign Currency Transactions

- A Canadian firm purchases merchandise with an invoice price of \$1,000 US on January 31, with payment due March 30, and a fiscal year end of February 28. What entries are necessary?
- At purchase, this entry would be made:

Purchases	1,530	
Accounts Payable		1,530

Foreign Currency Transactions

- By the end of the fiscal year, the firm has incurred a \$20 loss, as the firm is now liable for C\$1,550, rather than the C\$1,530 at which the transaction was initially recorded.
- Conceptually, there are essentially three alternatives at year end: The firm could:
 - Ignore the fluctuation
 - Adjust the amount of the purchase (called the one transaction approach), or
 - Recognize the change in currency value as an exchange loss (the two transaction approach)

Foreign Currency Transactions

- Ignoring the loss is potentially dangerous
- Adjustment of the price of the transaction does not reflect the real economic events
- The two transaction approach is the preferred (and generally accepted) alternative
- *The recognition of the exchange rate fluctuation as a separate economic event is consistent with the view that the purchase is entirely separate from any arrangement which may have been made for payment*

Foreign Currency Transactions

- At fiscal year end, the recognition of the loss is recorded in the following manner

Foreign Currency Loss	20	
Accounts Payable		20

- At this time, *the foreign currency liability is now reported at its Canadian dollar equivalent, and the loss is recognized in the period in which it has occurred.*

Foreign Currency Transactions

- At final payment, this entry is made:

Accounts payable	1,550	
Foreign Currency Loss	10	
Cash		1,560

- This further loss is also recognized in the period in which it occurs
- *In all cases, **the foreign currency loss is a period cost**, recognized in the period in which the change in exchange rates took place*

Hedging

- Foreign currency losses can be significant, and prudent management suggests that they should be guarded against if possible
- Hedging, in order to limit losses, may be accomplished in several ways:
 - Through offsetting amounts arising in the normal course of business
 - Through cash or revenue flows expected in the foreign currency
 - Through holding of assets in the foreign location
 - Through swaps, options, and futures contracts
 - Through forward contracts

Accounting for forward contracts

- Under a forward contract, a financial institution agrees to exchange currencies at a future date at a rate set when the contract is entered
- A forward contract is in some respects an executory contract and so some firms make no formal entries
- Generally, however, the binding nature of the forward relationship leads to journal entries which take a prescribed sequence

Accounting for forward contracts

- When an existing monetary position is hedged:
 - Record the transaction (purchase/sale)
 - Set up the forward contract vs the payable or receivable to/from bank
 - At statement dates:
 - Revalue the original payable/receivable
 - Revalue the forward contract
 - Value of payable/receivable to bank not changed
 - Amortize the premium on the forward contract
 - At settlement, repeat the procedures of the statement date, and record all cash flows executed

Costs and risks of forward contracts

- The costs of forward contracts include the direct costs of the forward premium and the costs of administration of the foreign currency denominated items by the company
 - The principal benefit is the alleviation of risk
 - Known future cash flows enable better planning
- Not all risks are eliminated by forward contracts
 - A significant risk is the opportunity cost of favourable exchange fluctuations having been foregone - that is, the firm has lost opportunities for gains

Hedging a commitment

- When a purchase or sale of goods or services in a foreign currency is hedged before the transaction, the Canadian dollar price of such goods or services is established by the terms of the hedge
- Any costs associated with the hedge would be included in the Canadian dollar price of the goods or services acquired or sold

Hedging: Handbook Provisions

- If a foreign exchange contract, asset, liability or future revenue stream is to be regarded as a hedge of a specific foreign currency exposure:
 - it should be identified as a hedge of the item(s) to which it relates; and
 - there should be reasonable assurance that it is and will continue to be effective as a hedge.

Hedging: Handbook Provisions

- There are many ways in which hedging may be accomplished, without necessarily incurring contractual commitments
- The Handbook and international practices include acknowledgement that *implicit hedges can include offsets as well as future cash flows in foreign currencies and assets in foreign locations which could be sold*
- Full disclosure of hedging practices of the firm in the notes to the financial statements is very useful to statement readers

Hedging Practices



Foreign Exchange Contracts

The Company operates globally, which gives rise to a risk that its earnings and cash flows may be adversely impacted by fluctuations in foreign exchange. The Company uses foreign exchange contracts to manage foreign exchange risk from its underlying customer contracts. In particular, the Company uses foreign exchange forward contracts and foreign exchange range forward contracts for the sole purpose of hedging certain of the Company's future committed U.S. dollar and Euro ["€"] outflows and inflows. Gains and losses on these hedging instruments are recognized in the same period as, and as part of, the hedged transaction. The Company does not enter into foreign exchange contracts for speculative purposes.

- *This hedging policy reported by Magna International is typical of Canadian multinational firms, and represents an integral part of cash flow management of the firm*

Hedging Practices

AIR CANADA



Risk Management

2000 Annual Report

The Corporation manages its exposure to changes in interest rates, foreign exchange rates and jet fuel prices through the use of various derivative financial instruments for the purpose of hedging existing commitments or obligations, not for generating trading profits. Most hedging takes place within a one-year time horizon and is principally in support of cash management activities. Longer term hedging is done infrequently and essentially supports financing activities.

- *Foreign currency hedging policies are part of an overall comprehensive cash flow and risk management strategy for Air Canada*

Hedging Practices

AIR CANADA



2000 Annual Report

The Corporation also manages foreign exchange exposure through the use of options, forward contracts and cross-currency swaps. During 2000, the Corporation purchased foreign exchange contracts that effectively converted 174 million Swiss franc debt into US dollars and the remaining 12 million Swiss franc debt into Canadian dollars. At December 31, 2000, approximately 5 per cent of the balance sheet exposure on Japanese yen debt was covered by short-term foreign exchange option contracts. No foreign exchange currency contracts were in place covering the principal amount of US debt. Aircraft assets, recorded on the balance sheet at historical exchange rates at the time of acquisition, are essentially US dollar-based assets which can provide a longer term economic hedge against US dollar currency movements.

- *This is part of the extensive disclosure of Air Canada*

International View

Rolls-Royce plc

Treasury instruments

The accounting treatment of the key instruments used by the Group is as follows:

- i) Gains or losses arising on forward exchange contracts are taken to the profit and loss account in the same period as the underlying transaction.
- ii) Net interest arising on interest rate agreements is taken to the profit and loss account.
- iii) Premiums paid or received on currency options are taken to the profit and loss account when the option expires or matures.
- iv) Gains or losses arising on jet fuel swaps are taken to the profit and loss account in the same period as the underlying transaction.

- *Procedures on currency transactions and hedges are broadly similar in other countries*

International View

HEINEKEN N.V. FINANCIAL STATEMENTS 2000

Hedging transactions are concluded solely to minimize the foreign exchange risks on receivables and debts as well as on future cash flows in foreign currencies which are virtually certain to occur. Forward contracts and options are used for this purpose. Before hedging, the incoming and outgoing cash flows of a given currency are netted centrally as far as is possible. Where forward contracts have been concluded to hedge positions in foreign currencies, these positions are translated at the rate of exchange at which they were hedged. The recognition of gains and losses arising from the translation of currency transactions entered into for the purpose of hedging future cash flows in foreign currencies is deferred until the time the relevant cash flows are accounted for. Commercial transactions denominated in foreign currencies are entered in the statement of income at the current spot rate or at the forward rate where forward contracts have been concluded in connection with these transactions.

- *Comprehensive disclosure of translation and hedging policies is provided by many firms*

Reference

Secord, Peter. 2003. *Modern Advanced Accounting*.
Canada: McGraw-Hill.