Learning unit 7 – Effects of changes in foreign exchange rates

Disclaimer

The information contained in the summary is to highlight important aspects in applying the principles of the applicable statements. The summary is in no way an indication that only the matters mentioned are important to pass. Students must refer to their study guides and textbooks for an understanding of the learning unit.

The summary below is primarily a revision tool to assist students in preparation of the exam.

Uncovered transactions – NO FEC taken out

Important definitions

Monetary items	Non monetary item	Spot rate	Closing rate
Right to receive fixed units of currency	**Absence** of the right to receive fixed units of currency	Exchange rate for immediate delivery	Spot rate at year-end
Eg: Creditor, cash/dividends	Eg: PPE, Inventory, Intangible assets	Rate on a specific date	

Initial measurement

Example:

On 1 March 2013, A Ltd ordered inventory to the value of $10 000 from Foreign Co, a US based company. The inventory was shipped free on board (FOB) on 1 June 2013 and A Ltd received the inventory on 26 June 2013.

Applicable spot rates:

Date	$1 =R
1 March 2013	9.57
1 June 2013	9.80
26 June 2013	9.87

Discussion:

Principle: The spot rate on the transaction date is used for translation purposes.

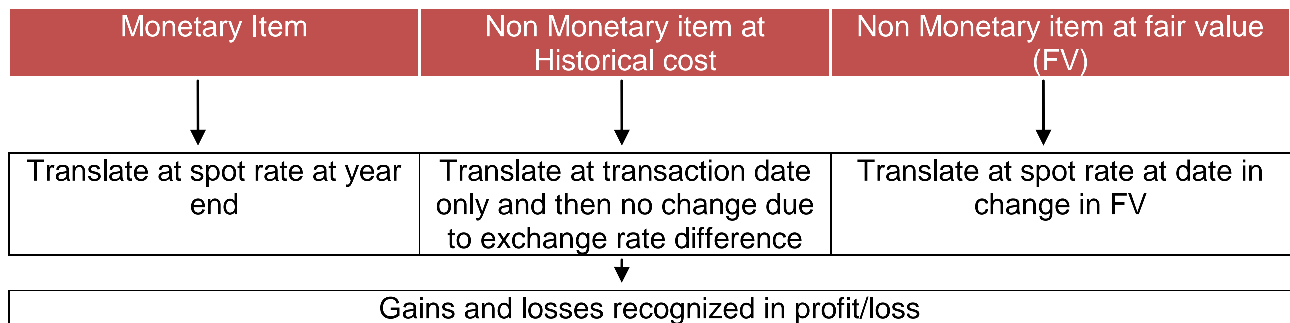
The **date of the transaction** is the date on which the transaction first qualifies for recognition in accordance with IASs. (IAS 21.22)

Application: Transaction date is when risks and rewards pass to A Ltd. This is when the inventory was shipped FOB (1 June 2013). Therefore A Ltd will record the asset at: $10 000 x 9.80 = R98 000

Journal:

Dr Inventory	R98 000	
Cr Creditor		R98 000

Subsequent measurement



Example:

Let's assume that A Ltd, above, has a 30 June year end. Exchange rate at 30 June 2013: $1 = R9.57

Discussion:

1. **Monetary item = creditor =** translate at spot rate at 30 June 2013

Recorded at ($10 000 x R9.80)	R98 000
Balance at year end ($10 000 x R9.57)	R97 500
Foreign exchange profit	R 500

Thus the creditor value is now R97 500.

Journal:

Dr Creditor	R 500	
Cr Foreign exchange profit (P/L)		R 500

2. **Non -monetary item = Inventory = No change**

Refer:
Example 3-5 of learning unit 7

Covered transactions – FEC taken out

Important definitions

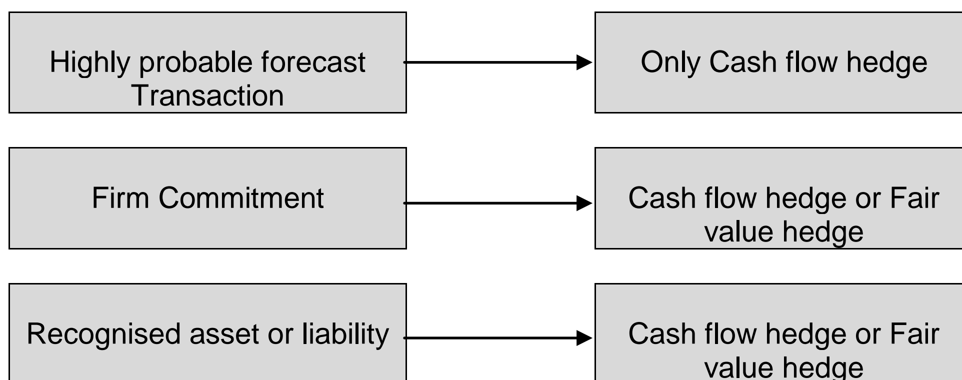
Hedge item	Hedge instrument	Firm Commitment
↓	↓	↓
Eg: Creditor, debtor	Only FEC's at 3rd year	Eg: Non cancellable order

General – 2 types of hedges

Fair value hedge	Cash flow Hedge
which **hedges the exposure to changes in fair value of a recognised asset or liability or** an unrecognised firm commitment or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss;	which **hedges the exposure to variability in cash flows** that: – is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments or variable rate debt) or a highly probable forecast transaction; and – could affect profit or loss;

Firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

The hedging relationship with regards to **foreign currency risk** can be depicted as follows:



Fair value hedge

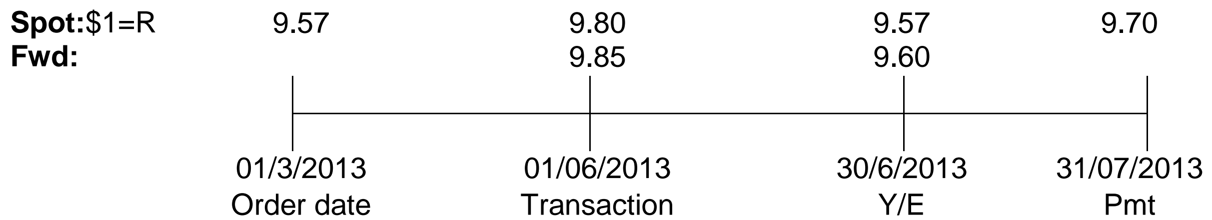
Example:

On 1 March 2013, A Ltd ordered inventory to the value of $10 000 from Foreign Co, a US based company. The inventory was shipped free on board (FOB) on 1 June 2013 and A Ltd received the inventory on 26 June 2013. A Ltd will pay Foreign co the outstanding amount on 31 July 2013. A Ltd has a 30 June year end

A FEC is taken out for the period 1 June 2013 to 31 July 2013 to hedge the company against changes in the fair value of the foreign creditor. Assume that none of the inventory was sold at year end. Applicable exchange rates were as follows:

Applicable spot rates:

Date	**Spot rate = $1 =R**	**Forward rate = $1 = R**
1 March 2013	9.57	
1 June 2013	9.80	9.85
26 June 2013	9.87	9.87
30 June 2013	9.57	9.60
31 July 2013	9.70	



Hedge item	Hedge instrument
↓	↓
Creditor	FEC

Order date 1/3/2013	
No entry	No entry

Transaction date: 1/06/2013	
Dr Inventory R98 000 Cr Creditor R98 000 $10 000 x 9.80	FEC taken out – No entry

Year end: 30/06/2013	
Dr Creditor R2 300 Cr Foreign exchange difference R2 300 ($10 000 x (9.80 – 9.57)) Refer above for explanation - subsequent measurement of monetary and non monetary items	Dr Foreign exchange difference R2 500 Cr FEC liability R2 500 ($10 000 x (9.85 – 9.60)) where the entity's **financial year end occurs before settlement date,** the gain or loss (recognised in profit or loss) on the FEC is calculated by **multiplying the foreign currency amount of the FEC by the difference between the contracted forward rate and the forward rate available for a similar FEC for the remaining period till maturity** of the original contract. A corresponding forward exchange asset or liability (derivative) is raised

Settlement date: 31/07/2013	
Dr Foreign exchange difference R1 300 Cr Creditor R1 300 ($10 000 x (9.57 – 9.70)) Re-measure hedge item to rate on settlement	Dr FEC liability R1 000 Cr Foreign exchange difference R1 000 ($10 000 x (9.60 – 9.70)) Re-measure hedging instrument
Dr Creditor ($10 000 x 9.70) R97 000 Dr FEC Liability R 1 500 Cr Bank ($10 000 x 9.85) R98 500 Settlement of FEC and creditor	

Cash Flow hedge

Example:

On 1 March 2013, A Ltd ordered inventory to the value of $10 000 from Foreign Co, a US based company. The inventory was shipped free on board (FOB) on 1 June 2013 and A Ltd received the inventory on 26 June 2013. A Ltd will pay Foreign co the outstanding amount on 31 July 2013. A Ltd has a 30 June year end

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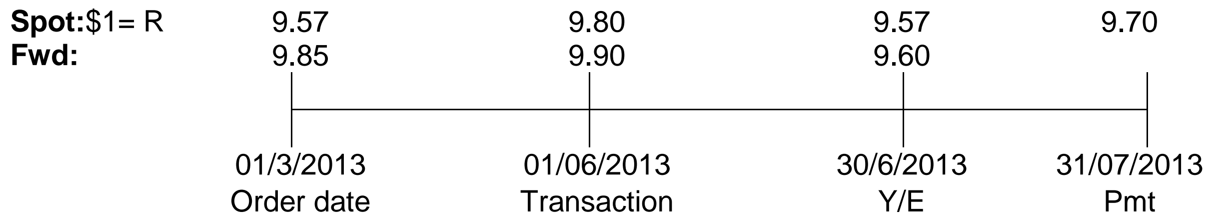

Hedge item	Hedge instrument
↓	↓
Creditor	FEC

Order date 1/03/2013	
No entry	No entry FEC taken out

Transaction date: 01/06/2013	
Dr Inventory R98 000 Cr Creditor R98 000 ($10 000 x 9.80) Dr Inventory R 500 Cr Cash flow reserve reserve R 500	Dr FEC asset R 500 Cr Cash Flow hedge reserve R 500 ($10 000 x (9.85 – 9.90))

the resulting gain or loss on the hedging instrument is treated as follows: if it is an **effective hedge** it shall be recognised in other comprehensive income

Based on company policy – refer par 7.12 of learning unit

Year end: 30/06/2013	
Dr Creditor R2 300 Cr Foreign exchange difference R2 300 ($10 000 x (9.80 – 9.57)) Refer above for explanation subsequent measurement of monetary and non monetary items	Dr Foreign exchange difference R3 000 Cr FEC liability R2 500 Cr FEC Asset R 500 ($10 000 x (9.90 – 9.60)) where the entity's **financial year end occurs before settlement date,** the gain or loss (recognised in profit or loss) on the FEC is calculated by **multiplying the foreign currency amount of the FEC by the difference between the contracted forward rate and the forward rate available for a similar FEC for the remaining period till maturity** of the original contract. A corresponding forward exchange asset or liability (derivative) is raised

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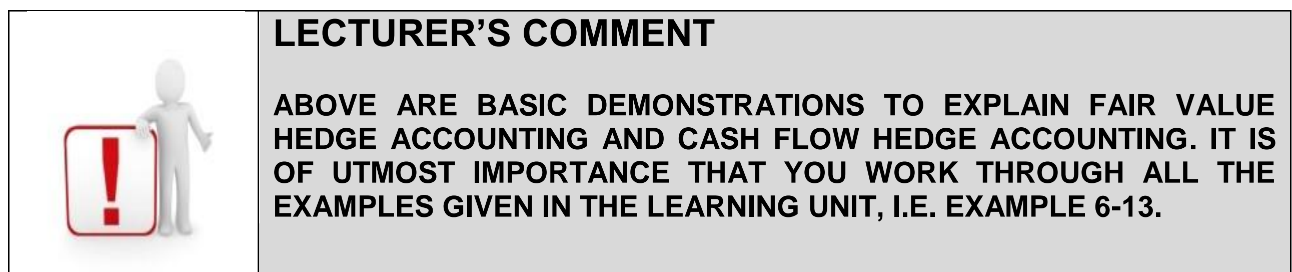
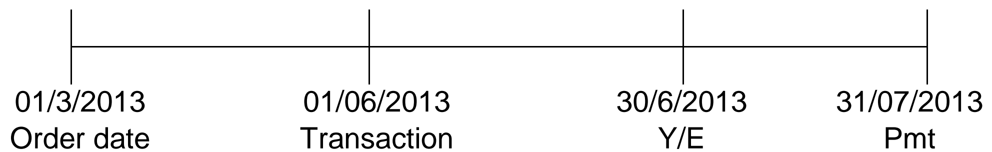


Hints and tips

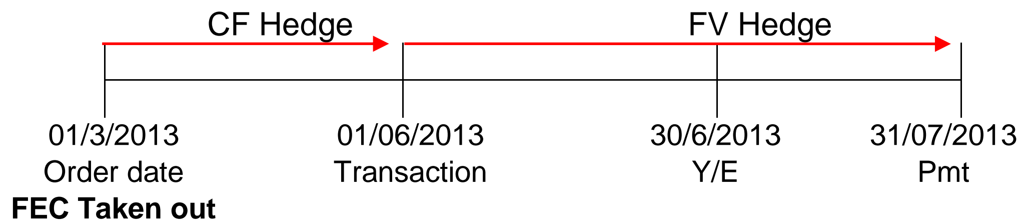
Exam technique

- Read the question carefully.
- Draw a timeline of events and clearly mark the events occurring. This will assist you in determining when and how the events occur and assist in presenting a logical solution.

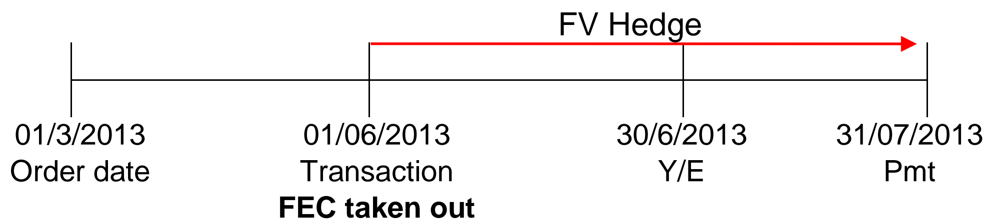
  Example:



- Determine if the FEC is taken out before or on/after transaction date.
  - Before transaction date = cash flow hedge



  - On/After transaction date = fair value hedge



  - A hedge of the foreign currency risk of a **firm commitment** may be accounted for as a fair value hedge or as a cash flow hedge. Note the accounting policy stated in the question.

- Account for the relevant transactions at each significant date. REMEMBER to account for the hedge item and hedge instrument.
- Remember to include in your solution the dates of the transactions.
- PRACTICE, PRACTICE, PRACTICE!