

## Lecture 5

**Functional currency:** Currency of the primary economic environment in which the entity operates.

**Presentation currency:** Currency in which the financial report is presented.

**Foreign Currency:** Currency other than the functional currency of the entity.

Spot exchange rate (**Spot rate**): Exchange rate for immediate delivery.

**Closing rate:** Spot rate at end of reporting period.

**Forward rate:** Negotiated/quote rate for delivery of a currency at a specified date in the future

### Journal Entries for Foreign Currency Transaction (Unhedged)

#### 1. Recording at transaction date at **spot rate**

Determination of transaction date will depends on the term of transaction, if

FOB destination – Title passes when goods arrived (Delivery Date)

FOB shipping point – Title passes when goods shipped (Order Date)

Purchase

|    |                                |
|----|--------------------------------|
| Dr | Inventory                      |
| Cr | Trade/Foreign Currency Payable |

Sell

|    |                                   |
|----|-----------------------------------|
| Dr | Trade/Foreign Currency Receivable |
| Cr | Sale                              |
| Dr | Cost of goods sold                |
| Cr | Inventory                         |

#### 2. Recording at Reporting Date i.e. 30 Jun

Foreign currency monetary items are re-measured at spot rate at reporting date.

Foreign currency gain/loss recognized in P&L at reporting date regardless if they are realized or unrealized.

If Gain

|    |  |
|----|--|
| Dr | Trade/ Foreign Currency Payable or Trade/Foreign Currency Receivable |
| Cr | Foreign Currency Gain  |

If Loss

|    |  |
|----|--|
| Dr | Foreign Currency Loss  |
| Cr | Trade/ Foreign Currency Payable or Trade/Foreign Currency Receivable |

#### 3. Recording at Settlement Date

Foreign currency monetary items are re-measured at spot rate at settlement date i.e. refer to entries (2) above.

Also, settlement of payments.

Sell

|    |                                   |
|----|-----------------------------------|
| Dr | Bank                              |
| Cr | Trade/Foreign Currency Receivable |

Purchase

|    |                                |
|----|--------------------------------|
| Dr | Trade/Foreign Currency Payable |
| Cr | Bank                           |

### Journal Entries for Foreign Currency Transaction with Qualifying Assets

- Foreign currency gains or losses relating to loans or other payables associated with qualifying assets are capitalized to the asset
- Can only capitalize to the extent that the asset's carrying amount does not exceed its recoverable amount
- Example: Purchases of materials used in constructing a bridge

#### 1. Recording at transaction date

|    |                                |
|----|--------------------------------|
| Dr | Bridge under construction      |
| Cr | Trade/Foreign Currency Payable |

#### 2. Recording at reporting date

If Gain

|    |                                 |
|----|---------------------------------|
| Dr | Trade/ Foreign Currency Payable |
| Cr | Bridge under construction       |

If Loss

|    |                                 |
|----|---------------------------------|
| Dr | Bridge under construction       |
| Cr | Trade/ Foreign Currency Payable |

#### 3. Recoding at settlement date

Re-measured at spot rate at settlement date i.e. refer to entry (2) above.

Also, settlement of payments.

|    |                                |
|----|--------------------------------|
| Dr | Trade/Foreign Currency Payable |
| Cr | Bank                           |

### Hedge Transactions

- A hedging instrument is a designated derivate whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.
- A hedging contract is a separate transaction to the original foreign currency transaction
- A hedge contract can be either a
  - (1) Specific commitment hedge (our focus) - hedging of a specific FC transaction
  - (2) General commitment hedge – hedging of an overall exposure to foreign currencies
- The aim of the hedge is to lock in the purchase/selling price  
i.e. paying or receiving a pre-determined amount as settlement of FC payable/receivable
- Types of Hedges:
  - (a) Fair value Hedge: A hedge of the exposure to change in the fair value of a recognized asset or liability that is attributable to a particular risk and could affect profit or loss.
  - (b) Cash flow Hedge: A hedge of the exposure to the variability in cash flows that is

attributable to a particular risk that is associated with all, or some component of, a recognized asset or liability or a highly probable forecast transaction and could affect profit or loss.

#### Conditions for a hedging relationship

A hedging relationship qualifies for hedge accounting if only ALL of the following conditions are met:

1. There is formal designation and documentation of the hedge relationship at time hedged entered into.
2. The hedge is expected to be highly effective.  
A hedge is regarded as highly effective if:
  - (a) The hedge is expected to be highly effective in achieving offsetting changes in fair value of cash flows attributable to the hedge risk, and
  - (b) The actual results of the hedge are within the range of 80% to 125%.
3. The underlying transaction is highly probable and presents an exposure to foreign exchange gains and losses.
4. The effectiveness of the hedge can be reliably measured.
5. The hedge is assessed to have been highly effective.

#### Journal Entries for forward contract (Illustrate with foreign currency transaction)

1. At the inception of the forward contract  
No journal entries required.
2. Transaction Date  
If forward contract entered before transaction date, changes of rate is designated as cash flow hedge.

#### **Gain (CF hedge)**

|    |   |
|----|---|
| Dr | Forward Contract                                |
| Cr | Gain on foreign currency to Hedge Reserve (OCI) |

Purchase (FC transaction), and reduction of cost of inventory due to gain in CF hedge

|    |   |
|----|---|
| Dr | Inventory                                   |
| Dr | Transfer From Cash Flow Hedge Reserve (OCI) |
| Cr | Trade/ Foreign currency payable             |

Sale (FC transaction), and incremental of sales due to gain in CF hedge

|    |                                     |
|----|-------------------------------------|
| Dr | Accounting Receivable               |
| Dr | Transfer From Cash Flow Hedge (OCI) |
| Cr | Sales Revenue                       |

|    |                    |
|----|--------------------|
| Dr | Cost of goods sold |
| Cr | Inventory          |

#### **Loss (CF hedge)**

|    |   |
|----|---|
| Dr | Loss on foreign currency to Hedge Reserve (OCI) |
| Cr | Forward contract                                |

Purchase (FC transaction), and incremental of cost of inventory due to loss in CF hedge

|    |                                     |
|----|-------------------------------------|
| Dr | Inventory                           |
| Cr | Reclassification from reserve (OCI) |
| Cr | Trade/ foreign currency payable     |

Sale (FC transaction), and reduction of sales due to loss in CF hedge

|    |                                     |
|----|-------------------------------------|
| Dr | Accounting Receivable               |
| Cr | Reclassification from reserve (OCI) |
| Cr | Sales Revenue                       |

|    |                    |
|----|--------------------|
| Dr | Cost of goods sold |
| Cr | Inventory          |

### 3. Reporting Date

If Gain (Foreign currency)

|    |                                 |
|----|---------------------------------|
| Dr | Trade/ Foreign Currency Payable |
| Cr | Foreign Currency Gain           |

If Loss (Foreign currency)

|    |                                 |
|----|---------------------------------|
| Dr | Foreign Currency Loss           |
| Cr | Trade/ Foreign Currency Payable |

If Gain (Forward contract)

|    |                          |
|----|--------------------------|
| Dr | Forward contract         |
| Cr | Gain on Forward contract |

If Loss (Forward contract)

|    |                          |
|----|--------------------------|
| Dr | Loss on Forward contract |
| Cr | Forward contract         |

### 4. Settlement Date

Re-measured at spot rate and forward rate i.e. entry (3).

And, Settlement of both Trade payable/receivables and forward contract.

Purchase

|    |                                |
|----|--------------------------------|
| Dr | Trade/Foreign Currency Payable |
| Cr | Bank                           |

Sell

|    |                                   |
|----|-----------------------------------|
| Dr | Bank                              |
| Cr | Trade/Foreign Currency Receivable |

Forward Contract (payment of total gain/loss)

|    |                  |
|----|------------------|
| Dr | Forward Contract |
| Cr | Bank             |

Or

|    |                  |
|----|------------------|
| Dr | Bank             |
| Cr | Forward Contract |

