

Accounting for Forex and Hedging

Presenter: Caryn Maitland CA(SA)

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Presenter

Caryn Maitland

Caryn is a qualified CA(SA and RA, who has lectured extensively at UKZN (and other institutes) where she lectured Advanced Financial Accounting up until 2011 as well as co-ordinating the module on the Pietermaritzburg campus and was appointed Section Head of Financial Accounting and Deputy Head of the School of Accounting (managing the Pietermaritzburg campus) prior to leaving UKZN.

She has conducted independent workshops and seminars for professional accountants since 2006 on various topics and has consulted on a number of technical issues. Since January 2011, she has focused on her own business as technical freelance consultant and trainer to those working within the accounting profession. Caryn is a technical advisor to the SAICA Eastern Region Midlands District, Northern District and Southern District Associations, as well as the Small Practice Interest Group in Durban – specialising in financial reporting (IFRS, IFRS for SME's and general accounting), assurance, legislation and ethics. Caryn has a passion for Corporate Governance, which together with her Companies Act specialism and Financial Management for Non Financial Management lecturing background, has served her well in consulting and advising various Boards of Directors in recent years.

Caryn is also a platform presenter for various institutes as well as many small to medium accounting practices across the country and into Southern Africa. Maitland was appointed as a visiting Associate Professor to the University of Limpopo tasked with mentoring their Financial Accounting staff (Aug 2011 to Dec 2013).

Maitland's passion is IFRS and IFRS for SME's and was delighted at the opportunity granted in 2013 to serve on the APC subcommittee constituted to investigate the need for Micro GAAP and the role of IFRS for SME's for small and medium sized practitioners. Caryn, also serves on the Joint Accountants, Auditors and Attorneys Committee of SAICA, and is part of the School Governing Body project initiated by SAICA in KwaZulu-Natal, and has been appointed as an alternative member to the APC in June 2020

Caryn was elected as the first woman Chairperson for the Midlands District Association for SAICA in 2018 and also serves on the Eastern Region SMP Committee as well as the Local Subvention Committee for SAICA. In 2019 Caryn was appointed to the SAICA Eastern Region Council. As someone who is committed to environmental affairs, Caryn serves as a non-executive director for the Institute of Natural Resources, a Non Profit Company focusing on research. Since 2018 Caryn has worked extensively with commerce and industry, assisting analysts, directors and other users of financials to interpret, prepare, analyse and forecast based on the results of financial statements.



Why is it important?

- South African context
- Work in a global economy
- Translation of transactions
- Valuation of balances and transactions
- Managing risk
- Which exchange rate do we use, when??

Functional vs Presentation Currency

- Functional currency – measurement
 - Primary economic environment
 - Identified by factors
- Primary factors: Currency
 - That mainly influences sales prices (usually denominated in and settled)
 - Of country whose competitive forces, regulations and market conditions determine sales prices
 - Labour, material and other costs are denominated and settled

- Secondary factors
 - Currency in which funds from financing activities are generated
 - Currency in which net receipts from operating activities retained
- Functional currency is not a free choice, but presentation currency is

Basic FOREX transactions

- SPOT RATE at the date the Risks and Rewards pass
 - Free on Board (FOB)
 - Carriage, insurance freight (CIF)
- Non monetary items vs Monetary items
- Important dates:
 - Date of R&R
 - Year ends (other reporting dates)
 - Settlement date

Example: Basic transaction

- \$100 000 machine purchased
 - R&R pass on 1 February 2021
 - Year end 30 June 2021
 - Settle foreign creditor 31 October 2021
- Spot rates:
 - 1 February 2021 R14.00 :\$1
 - 30 June 2021 R13.00 :\$1
 - 31 October 2021 R 13:50 :\$1
- Timeline:

Basic Forex Journals

Account	Workings	Dr	Cr
Plant	1/2/2018: 100 000 x 14	1 400 000	
Foreign Creditor			1 400 000
Foreign Creditor	30/6/2018: (14-13)x100k	100 000	
Forex Gain (P&L)			100 000
Forex Loss (P&L)	31/10/2018: (13-13.50)x100k	50 000	
Foreign Creditor			50 000
Foreign Creditor	1 400 000 -100 000 + 50 000	1 350 000	
Bank	TEST: 100 000 x 13.50		1 350 000

Exceptions to the rule – non monetary Assets

- Impairment
 - Cost or Carrying amount translated at historic spot
 - FV less costs (“NRV”) or recoverable amount – spot rate at date determined
 - EG Commodity price moves from \$100 to \$75, and exchange moves from R13:\$1 to R11:\$1
 - American branch has a building, functional currency is the Rand...
- Revaluations of assets denominated in foreign currency...

Hedging

Different standard (IFRS 9) different transaction, different timeline!!!

Can hedge (IFRS 9):

- Recognised asset
- Recognised liability
- Unrecognised firm commitment
- Forecast transaction
- Net investment in foreign operation

- Features: exposes entity to risk of
 - Changes in fair value, or
 - Variability of future cash flows, and is
- DESIGNATED by the entity as being hedged

Hedged item and hedging instrument

- Hedging instrument is a derivative (eg FEC) whose fair value or cash flows is expected to
 - Offset changes in the FV of CF of designated hedged item
- A non derivative financial asset/liability may be designated as a hedging instrument **only** as a hedge for FOREX risk
- **Designation:** hedging relationship is designated in its entirety
 - **Exception is FOREX:** can designate full movement in value of FEC or just spot rate
 - **Difference between spot and forward rate:** interest differential

Mechanics of hedging

- Mark to Market:
- Create a financial asset/liability with movement in forward rate
- Gain and Losses – Profit and Loss or Equity??

Poll: can you measure your imported inventory at the forward rate?

- Yes
- No

Hedge future transactions

- Hedge of a forecast transaction
 - Uncommitted but anticipated future transaction
 - Date that FEC is entered into until firm commitment
- Hedge of a firm commitment
 - Binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date
 - Eg an irrevocable purchase order
 - Date from when firm commitment is entered into to date of R&R

Timelines



Tale of Two TimeLines

- Important dates
 - Date FEC entered
 - Firm commitment date
 - Risk and rewards date
 - Year ends
 - Settlement date

Cash Flow Hedges

- Unique to Forex
- Protecting the creditor
- Starts from when hedging a highly probable anticipated transaction
- Cash Flow Hedge Reserve
 - Gains and losses go to equity and then either apply the basis or recycling approach

Cash flow hedges

- On 1 June 20.4, Spring Limited took out a 9-month dollar FEC to acquire \$50 000 in respect of an anticipated inventory order to follow.
- Spring limited duly placed an irrevocable order with supplier for inventory costing \$50 000 on 1 September 20.4. The risk and rewards associated with the inventory passed to Spring Limited 1 December 20.4.
- Payment was made on the scheduled due date of 1 March 20.5.

Cash flow hedges

- The inventory was sold evenly over the two years ending 31 December 20.6
- Spring Limited's accounting year-end was 31 December.
- Interim financial statements are prepared on 30 June.
- The hedge was considered to be perfectly effective. Ignore taxation.

Cash flow hedges

- Required:
- Draft journal entries to record all matters relating to the above transactions in the accounting records of Spring Limited assuming:
 - The designated hedging relationship in changes in the fair value of the FEC as a whole.
 - The hedge of the firm commitment is accounted for as a cash flow hedge
 - From transaction date, the FEC is designated as a fair value hedge of changes in the fair value of the foreign creditor.

Fair value hedge

- Hedging changes in fair value
- Protecting the underlying asset
- Can hedge full movement in forward rate or just spot element

Fair value hedges

- Required: Same example as above, except that the hedge of firm commitment is accounted for as a fair value hedge
- The designated hedging relationship in changes in the fair value of the FEC as a whole.
- From transaction date, the FEC is designated as a fair value hedge of changes in the fair value of the foreign creditor.

Hedging of a Net Investment in Foreign Operation

- Net investment in foreign operation
 - Amount of the reporting entity's interest in the net assets of that operation
- Example
 - 80% interest in equity of foreign sub whose net assets = R6million
 - Net investment = 80% of R6million = R4.8 million
- Included are monetary items receivable/payable from foreign op that settlement is neither planned or likely to occur in the foreseeable future
 - EG if you had a R2million "permanent" loan with the above foreign sub
 - Net investment = R4.8m + R2 m = R6.8m

- Separate AFS
 - Exchange differences arising from receivables and payables forming part of Net Investment in sub
 - to P&L
- In Consolidated AFS
 - OCI as part of Equity due to Foreign Currency Translation Reserve
 - Reclassified to P&L on disposal of sub

Net investment in a foreign operation

- Fuller Limited has the South African Rand as its functional currency and has a 31 December financial year-end.
- On 01 January 20.4 Fuller limited acquired 80% of the share capital of Holmes Inc. (a USA company) at a cost of \$80 000. at that date, Fuller Limited also advanced a \$20 000 dollar-denominated loan to Holmes Inc. for an indefinite period.

Net investment in a foreign operation

- Spot exchange rates were:

•	Rand : US\$
• 1 January 20.4	R9.00 : US\$1
• 31 December 20.4	R9.50 : US\$1

- Required:

- a) Prepare journal entries in the separate financial statements of Fuller Limited to record the exchange difference arising on the loan of \$20 000 to Holmes Inc. for the 20.4 year.
- b) Prepare the pro-form journal entry to account for the exchange arising on the loan of \$20 000 to Holmes Inc. in the 20.4 consolidated financial statements of Fuller Limited.

Net investment in a foreign operation

Solutions:

	Calculations:	<u>Rand</u>	<u>Rand</u>
Dr Foreign Loan	20 000 (R9.50 - R9)	10000	
Cr Forex gain / Loss (P/L)			10000
Gain on exchange difference			
Dr Forex gain / Loss (P/L)	20 000 (R9.50 - R9)	10000	
Cr Foreign currency translation reserve (OCI)			10000
Gain on exchange difference to OCI			

Hedge of a net investment in a foreign operation.

- Fuller Limited has the South African Rand as its functional currency and has a 31 December financial year-end.
- On 01 January 20.4 Fuller Limited acquired 80% of the share capital of Holmes Inc. (a USA company) at a cost of \$80 000.
- As a hedge against this investment, Fuller Limited borrowed \$80 000 from Yankee bank on 1 January 20.4. the loan from Yankee bank was designated as a hedge of the net investment in Holmes Inc.

Hedge of a net investment in a foreign operation.

- Spot exchange rates were:
 - Rand : US\$
 - 1 January 20.4 R9.00 : US\$1
 - 31 December 20.4 R9.50 : US\$1
- Required:
- Discuss the accounting treatment of the hedge of the net investment in Holmes Inc. in the 20.4 consolidated financial statement of Fuller Limited. Draft the pro-forma journal entry to account for the hedging relationship in the 20.4 consolidated financial statements of Fuller Limited.

Hedge of a net investment in a foreign operation.

- **Solution:**
- Fuller Limited will recognise exchange differences arising during 20.4 on the translation of the net assets of Holmes Inc (the foreign operation) in other comprehensive as a 'foreign currency translation reserve' regarding the loan from Yankee bank which is the designated hedging instrument in the hedge of the net investment in Holmes Inc., the loss arising on the loan will also be taken via other comprehensive income to the 'foreign currency translation reserve'

	Calculations:	<u>Rand</u>	<u>Rand</u>
Dr Foreign currency translation reserve (OCI)	80 000 (R9.50 - R9)	40000	
Cr Forex gain / Loss (P/L)			40000
Loss on exchange difference to OCI			

Other ideas

- Foreign loans
 - Interest
- Present Valuing of Hedging
- Discontinuance of Hedging
- Export transactions
- Ineffective Cash Flow Hedges

Disclosure

IFRS for SME considerations

QUESTIONS?

Other points

- SARS should prepopulate the refund rate for diesel
- You must be registered with SARS to claim this refund – it is NOT automatic
- http://www.treasury.gov.za/comm_media/press/2017/20170215001%20-%20REVIEW%20OF%20THE%20DIESEL%20FUEL%20TAX%20REFUND.pdf – updated process for claiming diesel refunds

Q&A

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**Thank you for your
participation**