

# ACCOUNTING FOR FOREIGN EXCHANGE RATE FLUCTUATION

# FOREIGN CURRENCY TRANSLATION:

- ▣ Translation refers to change in monetary expression of the financial data contained in the financial statements.
- ▣ Translation does not result in physical exchange of currencies.
- ▣ Physical exchange of currency is not permissible because repatriation is not allowed.

# Issues in foreign currency translation:

- ▣ International transactions and their recording
- ▣ Forward exchange contract
- ▣ Diversity in foreign currency translation
- ▣ International GAAP for foreign currency translation.

# International transactions and their recording

- ▣ I T refers to the buying or selling of goods and services which prices are denominated in foreign currency.
- ▣ Borrowing or lends funds and the amounts payable and receivable are denominated in foreign currency.

# Recording of Transaction :

## A) Date of Initiation:

It is the date on which the transaction was first initiated between the buyer and seller

## B) Interim date of reporting:

It is the date on which either or all the parties record their operating results ( i.e., difference between the date of initiation exchange rate and the current exchange rates.)

## C) Date of settlement:

It is the date on which the transaction referred to under the date of initiation is settled.

# APPROCHES:

## 1) SINGLE TRANSACTION APPROCH:

It is based on the assumptions that a foreign transaction and its subsequent settlement on a single event. Accordingly difference due to the exchange rate fluctuations are credited to the cost of goods purchased or to an export sale.

## 2) DUAL TRANSACTION APPROCH:

It is based on the assumption that foreign exchange involved in an international transaction and it is separate from that of the cost of goods purchased or sold.

# Journal entries in single transaction approach:

## A) DATE OF INITIATION:

Purchase A/C Dr

To Accounts payable/suppliers A/C .

(quantity purchased multiplied by exchange rate prevailing on the date of exchange)

## B) INTERIM DATE OF REPORTING:

Purchase A/C Dr

To Accounts payable/suppliers A/C .

(quantity purchased multiplied by exchange rate difference with the interim date and the date of initiation)

## C) SETTLEMENT DATE:

Inventories A/c Dr

To Accounts payable/suppliers A/c.

(quantity multiplied by additional change in the exchange rate between settlement date and interim date)

# Journal entries in dual transaction approach

## A) DATE OF INITIATION:

Purchase A/C Dr

To Accounts payable/suppliers A/C .

(quantity purchased multiplied by exchange rate prevailing on the date of exchange)

## B) INTERIM DATE OF REPORTING:

Loss on foreign exchange A/C Dr

To Accounts payable/suppliers A/C .

(quantity purchased multiplied by difference between the exchange rate on the interim date and the date of initiation)

## C) SETTLEMENT DATE:

Loss on foreign exchange A/c Dr

To Accounts payable/suppliers A/c.

(quantity multiplied by additional change in the exchange rate between settlement date and interim date)

Note: reverse will be entry for gain on foreign exchange.

## ▣ FINAL SETTLEMENT:

Accounts payable/Suppliers A/c Dr

To cash/ bank A/c.

# International GAAP on Foreign Currency Translation:

IAS 21(revised 1993) primarily deals with the provisions of foreign currency translation and transaction.

- ❖ Accounting for foreign currency transaction which are denominated in currency other than the functional currency of the enterprise
- ❖ Translation of foreign currency financial statements of branches, divisions, subsidiaries and other investors that are incorporated in the financial statement of an enterprise by consolidation methods.

- ❖ Functional currency is a term used under the US GAAP which, in the context of foreign currency translation, refers to the currency of the primary economic environment in which the enterprise operates.
- ❖ FCTs are transactions whose terms are denominated in a foreign currency or which require settlement in a foreign currency.

Such transaction occur when the enterprise

- a) Buys or sells on credit , goods or services whose prices are denominated in foreign currency.
- b) Borrows or lends funds and the amounts payable or receivable are denominated in foreign currency.

# An overview of Foreign currency markets and exchange rates:

## 1) Foreign currency markets:

-It plays a crucial role in global trade institutions such as banks can buy and sell currencies. as a result international trading and investment run smoothly.

## 2) Facts:

-The market is different from other exchanges is that it has no central location instead , it consists of traders who buy and sell currencies from their computers.

### 3) Benefits:

-unlike other markets, such as commodities the foreign currency market is highly liquid. Meaning asset can be quickly converted into cash. Traders can execute trades 24 hours per day , except weekends.

### 4) Functions:

-the main purpose of the foreign exchange market is to encourage international investment and trade. This market exchanges on currency into another currency.

Ex: European countries export products and services to the united states, the US can pay for these items in euro.

## 5) Types :

-The foreign currency market is one of the largest global markets. some of the players that trade in this market are central banks, speculators and corporations, individuals known as retail traders, make up a small part of this market. They cant trade directly but can conduct this task through a broker or bank.

# Foreign Exchange Rates

- ▣ Foreign exchange rates is a rate at which one currency may be converted into another.
- ▣ The exchange rate is used when simply converting one currency to another, or for engaging in speculation or trading in the foreign currency market.
- ▣ There are a wide variety of factors which influence the exchange rates such as interest rates, inflation and the state of politics and the economy in each country.

- ▣ In finance an exchange rate also known as foreign exchange rate, forex rate, FX rate or Agio.
- ▣ Exchange rate are determined in the foreign exchange market, which is open to wide range of different types of buyers on sellers where currency trading is continuous 24 hours a day except weekend i.e., trading from 20:15 GMT on Sunday until 22:00 GMT Friday. The spot exchange rate refers to the currency exchange rate.

# Accounting for Spot Currency Transaction:

- ▣ A foreign currency transaction is one that requires settlement, either payment or receipt, in a foreign currency.
- ▣ When the exchange rate changes between the original purchase or sale transaction and the settlement date , there is a gain or loss on the exchange.
- ▣ Business with few foreign currency transactions are more likely to convert currency on the spot or current rate.

# Steps to be followed to account the spot foreign currency transaction.

Step-1:

- ▣ Record the value of transaction in dollars at one exchange rate currency at the time of purchase or sale.

Step-2:

- ▣ Calculate the value of the payment in dollars at the current exchange rate when the transaction is settled.

### Step-3:

- ▣ Post the payments of the accounts receivables at the original rate and record the loss on exchange by accounting for the difference between the original transaction value and the settlement amount.

### Step-4:

- ▣ Calculate the value of foreign currency accounts receivable or payable at the spot rate at the year end of the accounting year record any change in value from the original transaction rate as a foreign currency gain or loss in the year and post the other side of the entry to accounts payable or accounts receivable as appropriate.