Statement of Accounting Standards **AAS 20A**
December 1987

Foreign Currency Translation

Prepared by the
Accounting Standards Board and the
Public Sector Accounting Standards Board of the
Australian Accounting Research Foundation

The National Councils of The Institute of Chartered Accountants in Australia and the Australian Society of Accountants issue the following Statement of Accounting Standards relating to "Foreign Currency Translation". This Statement, comprising Parts A and B which are alternative sets of requirements, supersedes the previous Statement issued in October, 1985.

Statements of Accounting Concepts and Statements of Accounting Standards are developed and maintained for the Councils by the Accounting Standards Board and the Public Sector Accounting Standards Board of the Australian Accounting Research Foundation, acting in concert. The processes applied by those Boards are outlined in "Foreword to Statements of Accounting Concepts and Statements of Accounting Standards".

This Statement applies to all reporting entities in the private sector and to those public sector reporting entities employing any accrual basis of accounting. The provisions of this Statement are also to be applied by other public sector reporting entities to the extent that it is practicable for them to do so.

This Statement is operative for any accounting period ending on or after 1 January, 1988. Earlier adoption is permitted.

If Part A, which includes accounting standards that employ the "immediate recognition method", is not adopted, Part B, which includes accounting standards that employ the "deferral and amortisation method", shall be applied. Part B shall not be reverted to once Part A has been adopted.

Part B will not be available for application to accounting periods ending after 1 January, 1991.

Subject to the matter identified in paragraph 43 of Part A, compliance with Part A of this Statement will ensure compliance with Approved Accounting Standard ASRB 1012: Foreign Currency Translation.

Issued by the
Australian Society of Accountants and
The Institute of Chartered Accountants in Australia

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APPENDICES

1 Translation of Financial Statements of Foreign Operations
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INTRODUCTION

1 This Part sets standards of accounting for the translation of:

(a) "foreign currency transactions", including "hedging" transactions; and,

(b) foreign currency financial statements.

The standards contained in this Part include standards that employ the immediate recognition method in respect of "exchange differences" on "long-term monetary items". This Part also requires certain disclosures in respect of "speculative dealing" in foreign currencies, but does not, as yet, set down methods of accounting for such dealing because of unresolved questions that it raises in relation to accounting for other similar speculative transactions which do not involve foreign currencies.

2 A Statement of Accounting Standards on foreign currency translation is considered necessary because Australian reporting entities are increasingly involved in "foreign currency transactions" and "foreign operations" and because changes in "exchange rates" have tended to be frequent and significant in their effect.

DEFINITIONS

3 For the purposes of this Part:

(a) **"Current rate method"** means a method of translating the financial statements of a "foreign operation" whereby:

(i) assets and liabilities are translated at the "exchange rate" current at balance date;

(ii) owners' equity at the date of acquisition (including, in the case of a corporation, share capital at acquisition and pre-acquisition reserves) is translated at the "exchange rate" current at acquisition date;

(iii) post-acquisition movements in owners' equity (other than retained profits or accumulated losses) are translated at the "exchange rates" current at the dates as at which those movements were recognised in the accounts, except that where such movements represent transfers between items within owners' equity, the movements are translated at the "exchange rates" current at the date that the amounts transferred were originally recognised in owners' equity;

(iv) distributions from retained profits (that is, dividends paid or proposed) are translated at the "exchange rates" current at the dates when the distributions were paid or proposed, as is applicable;

(v) post-acquisition movements in retained profits or accumulated losses, because of transfers from the profit and loss account or its equivalent, are recognised as a result of applying (vi) below for each reporting period; and,

(vi) revenue and expense items are translated at the "exchange rates" current at the dates as at which those items were recognised in the accounts.

(b) **"Discount (premium)"**, in relation to "foreign currency exchange rates", means the difference between the "forward rate" and the "spot rate", when the latter is the higher (lower) rate. (This definition assumes direct quotation of currencies.)

(c) **"Domestic"** means pertaining to the country of the reporting entity.

(d) **"Exchange difference"** means the difference resulting from translating the same number of units of foreign currency at differing "exchange rates".

(e) **"Foreign currency exchange rate"** ("exchange rate") means a ratio for the exchange of two currencies at a particular point in time.

(f) **"Foreign currency contract"** means an agreement to exchange, at a specified future date, different currencies at a specified exchange rate (the "forward rate").

(g) **"Foreign currency transaction"** means a transaction of the reporting entity denominated in a foreign currency.

(h) **"Foreign operation**" means a reporting entity, including a subsidiary, branch, division, associated company, partnership or the like, for which financial statements are prepared in a foreign currency.

(i) **"Hedging"** means action taken, whether by entering into a foreign currency contract or otherwise, with the object of avoiding or minimising possible untoward financial effects of movements in exchange rates.

(j) **"Integrated foreign operation"** means a foreign operation that is financially and operationally inter-dependent, either directly or indirectly, with the reporting entity and whose day-to-day operations normally expose the reporting entity to the effects of variations in exchange rates.

(k) **"Long-term monetary item"** means a monetary item which, when it originates, has a period of more than twelve months to settlement.

(l) **"Net investment"** means the reporting entity's proportionate ownership interest in the net assets of a foreign operation, together with any long-term intra-group balances related to the acquisition or financing of that operation.

(m) **"Qualifying asset"** means, in relation to the inclusion of exchange differences in the cost of acquisition thereof, an asset:

(i) under construction or otherwise being made ready for future productive use by the reporting entity in its own operations; or,

(ii) being constructed for the use of another entity pursuant to a construction contract (as covered by Statement of Accounting Standards AAS 11 "Accounting for Construction Contracts").

(n) **"Recoverable amount",** in relation to an asset, means the net amount that is expected to be recovered:

(i) from the total cash inflows less the relevant cash outflows arising from its continued use and through its subsequent disposal; or,

(ii) through its sale.

(o) **"Self-sustaining foreign operation"** means a foreign operation that is independent, financially and operationally, and whose operations do not normally expose the reporting entity to foreign exchange gains or losses.

(p) **"Speculative dealing"** means the taking of a position in a foreign currency, whether by entry into a foreign currency contract or otherwise, solely for the purpose or profiting from movements in the exchange rate for that currency.

(q) **"Spot rate**" means the exchange rate for immediate delivery of currencies to be exchanged.

(r) **"Temporal method"** means a method of translating the financial statements of a foreign operation whereby:

(i) monetary items are translated at the exchange rate current at balance date;

(ii) non-monetary items are translated at exchange rates current at the dates as at which those items were first recognised in the accounts or, where those items have been revalued (upwards or downwards), at exchange rates current at the dates of revaluation;

(iii) owners' equity at the date of acquisition (including, in the case of a corporation, share capital at acquisition and pre-acquisition reserves) is translated at the exchange rate current at acquisition date;

(iv) post-acquisition movements in owners' equity (other than retained profits or accumulated losses) are translated at the exchange rates current at the dates as at which those movements were recognised in the accounts, except that where such movements represent transfers between items within owners' equity, the movements are translated at the exchange rates current at the date that the amounts transferred were originally recognised in owners' equity;

(v) distributions from retained profits (that is, dividends paid or proposed) are translated at the exchange rates current at the dates when the distributions were paid or proposed, as is applicable;

(vi) post-acquisition movements in retained profits or accumulated losses, because of transfers from the profit and loss account or its equivalent, are recognised as a result of applying (vii) below for each reporting period; and,

(vii) revenue and expense items are translated at the exchange rates current at the dates as at which those items were recognised in the accounts, except that items (including depreciation) that relate to non-monetary items are translated at the rates used to translate those non-monetary items.

DISCUSSION

Translation of Foreign Currency Transactions

4 Foreign currency transactions need to be translated into domestic currency terms so that they can be recorded in the reporting entity's books of account. The following discussion relates to accounting for transactions which do not involve speculative dealing [refer to paragraph 3(p)] and which are not hedging transactions. Hedging is specifically covered in paragraphs 26 to 33.

5 Accounting for foreign currency transactions will involve one or more of the following stages:

(a) translation to record the transaction as at the transaction date;

(b) adjustments to monetary items (receivables or payables) resulting from the transaction to record the effect of movements in exchange rates subsequent to the transaction date; and,

(c) recording the settlement of those monetary items.

6 Entities may enter into contracts, or undertake other forms of transaction which result in monetary items that in form are denominated in the domestic currency, but which are in fact adjusted by reference to movements in exchange rates. An example of such a monetary item is a liability of the reporting entity which is denominated in the domestic currency, but subject to adjustment for movements in certain exchange rates. These contracts and transactions are to be treated as falling within the definitions of "foreign currency contracts" and "foreign currency transactions" [refer to paragraphs 3(f) and 3(g)].

7 The exchange rate relevant for paragraph 5(a) is the actual exchange rate current at the transaction date (but refer to paragraph 41).

8 At reporting dates subsequent to the transaction date, and at settlement, monetary items resulting from foreign currency transactions are translated at the exchange rates current at those

dates to determine the domestic receivable or payable. Where this involves applying differing exchange rates to those previously applied, there will be a need to account for the resulting exchange differences.

Disposition of Exchange Differences Relating to Transactions

9 Implicit in the measurement of the amounts of monetary items in the manner set out in paragraph 8 (that is, at current exchange rates) is acceptance of the view that the exchange rates current at balance date are, for the purposes of applying the accounting period concept, the most reliable available evidence of the exchange rates that will apply when those monetary items will ultimately be paid or received. To the extent that the amounts of those monetary items have varied since they were originally recognised, or last restated, the reporting entity has normally gained or lost. This is because there has been an increase in indebtedness to, or by, the reporting entity without any corresponding acquisition or giving up of control over resources. Accordingly, the exchange differences arising from restating monetary items to the current amount receivable or payable ought normally be taken as they arise, as gains or losses, to the profit and loss account or its equivalent.

10 The exceptions to the treatment of exchange differences in the manner described in paragraph 9 are when those differences are incurred in the acquisition or disposal of resources and need to be included in the measurement of those purchases or sales. Paragraph 13 addresses the situation in which a qualifying asset exists and exchange differences need to be capitalised. Paragraph 29 covers the treatment of exchange differences relating to certain hedging transactions, which differences need to be included in the pricing of an acquisition or sale of a good or service.

Foreign currency monetary items

11 Exchange differences on foreign currency monetary items are required to be calculated by translating the foreign currency amount of the monetary item at the spot rate current at the balance date, or, where the monetary item is settled during the accounting period, at the date of settlement, and by comparing the resulting amount with that same foreign currency amount translated at the date on which the original transaction took place (or, if later, the last balance date).

12 Exchange differences relating to foreign currency monetary items (other than those covered by paragraph 13) ought to be credited/debited to the profit and loss account or its equivalent (as exchange gains or losses) in the period in which they arise; that is, when the relevant exchange rates change.

Qualifying assets

13 This Part requires certain exchange differences to be included in the cost of acquisition of qualifying assets [refer to paragraph 3(m)]. These differences are limited to those arising in respect of monetary items that can reasonably be attributed to the qualifying assets. Furthermore, only those differences occurring before an asset ceases to be a qualifying asset are to be included. This Part does not permit exchange differences to be included in the cost of any other asset (including inventories), except for certain differences resulting from hedging transactions (refer to paragraph 29). The exchange differences to be included in the cost of qualifying assets for the period are the amounts that would otherwise have been credited/debited to the profit and loss account or its equivalent. It needs to be borne in mind when capitalising exchange differences that an asset ought not be carried at an amount in excess of its recoverable amount.

Translation of Foreign Currency Financial Statements

14 The objective of translating the financial statements of foreign operations into domestic currency terms is to enable incorporation of those financial statements into the reporting entity's financial statements and/or consolidated financial statements.

15 This Part takes the view that the method used to translate foreign currency financial statements ought to reflect the financial and other operational relationships which exist between the reporting entity and its foreign operations. Although these relationships will vary considerably, it is possible to classify foreign operations on the basis of whether the relationship normally exposes the reporting entity to exchange gains or losses. Some foreign operations are inter-related with those of the domestic operations in terms of financing, processing, marketing, distribution or other activities. Others are divorced from the domestic operations and the relationship is little more than that of investor and investee. The former category of foreign operations, termed integrated foreign operations, do expose the reporting entity to exchange gains or losses which can be measured through the translation of the financial statements of the foreign operations. The latter category, termed self-sustaining foreign operations, may, in the long run, expose the reporting entity to exchange gains or losses, but not through day-to-day operations. Accordingly, the process of translating the financial statements of a self-sustaining foreign operation is to facilitate consolidation rather than to measure exchange gains or losses arising out of relationships between components of the reporting entity.

16 This Part requires that where foreign operations are self-sustaining, the current rate method is to be used. Where the foreign operations

are integrated with those of the reporting entity, the temporal method is to be used. Appendix 1 sets out illustrative examples of these methods.

Criteria for classifying foreign operations

17 In determining whether a foreign operation is self-sustaining or integrated with the reporting entity, the governing determinant will be the effect of that operation's activities on the reporting entity's exposure to exchange gains and losses. Where, because of relative economic independence, the foreign operation's activities do not normally or materially expose the reporting entity directly to exchange gains and losses, the foreign operation is said to be self-sustaining; where this is not so, the foreign operation is said to be integrated. Factors which might, either individually or collectively, suggest that a foreign operation is self-sustaining include:

(a) the cash flows of the reporting entity are largely unaffected by the activities of the foreign operation;

(b) the sale prices of the foreign operations's products or services are not materially influenced by domestic conditions and such prices are primarily determined by factors other than changes in exchange rates;

(c) the foreign operation's major markets do not include the reporting entity's country;

(d) the foreign operation's costs are not materially affected by domestic prices;

(e) the foreign operation's day-to-day financing is not supplied by the reporting entity; and,

(f) there are no material inter-company transactions or other interchanges with the foreign operation in the course of normal activities.

Self-sustaining foreign operations

18 The major objective in translating the financial statements of a self-sustaining foreign operation [refer to paragraph 3(o)] is to incorporate them into the reporting entity's financial statements and/or consolidated financial statements in a manner which reflects the status of the reporting entity's investment in the self-sustaining foreign operation whilst showing the effect of items of revenue and expense from the viewpoint of the reporting entity. This objective will be best achieved by using the current rate method [refer to paragraph 3(a)] which applies the same exchange rate to all assets

and liabilities, and which translates items in the profit and loss account or its equivalent at the rates current when those items were recognised in the accounts (or at an average rate which approximates those rates).

19 Application of the current rate method will give rise to exchange differences where, at balance date, the opening net assets are translated at a different exchange rate than previously applied, and/or where revenue and expense items are translated at rates other than the rate current at balance date.

20 The exchange differences arising under the current rate method occur because of the need to prepare accounts and/or consolidated accounts for a reporting entity with components in different countries. These exchange differences may bear little or no relation to gains or losses which may ultimately occur in relation to transactions within the reporting entity or with parties external to that entity.

21 The translation of the financial statements of a self-sustaining foreign operation is a means of aggregation to allow an overall view. It would be inappropriate to view any resulting translation difference as a measure of gain or loss. This Part requires any such difference to be taken directly to a separate reserve titled "foreign currency translation reserve" in the share capital and reserves section of the balance sheet. This reserve may have a debit or credit balance.

Integrated foreign operations

22 The activities of a foreign operation may be so closely interlinked with the activities of the reporting entity that the reporting entity is normally exposed to exchange gains and losses. In these circumstances, the foreign operation is little more than an extension of the reporting entity's own activities.

23 Where an integrated foreign operation [refer to paragraph 3(j)] exists, the objective of translation will be to incorporate the effects of the foreign operation's activities into the reporting entity's financial statements in a manner that achieves the same effect as if those activities had been entered into by the reporting entity.

24 The objective stated in paragraph 23 will be best achieved by applying the temporal method [refer to paragraph 3(r)]. Under the temporal method, non-monetary assets are translated using historical rates of exchange. They are thus incorporated into the reporting entity's accounts and/or consolidated accounts at the amounts at which the reporting entity would have carried such assets had they been acquired by that entity itself and not by the foreign operation.

Exchange differences arise mainly from translating monetary items at current rates (i.e. in the same way as for the foreign currency monetary items of the reporting entity). If these exchange differences are accounted for in the manner set out in paragraphs 9 to 13 the accounting treatment will coincide with that applied by the reporting entity to its own exchange differences.

25 The historical rate applicable when a non-current non-monetary asset has been revalued is the exchange rate current at the date of revaluation. The full amount by which the translated carrying amount of that asset is restated is required to be treated as a revaluation increment or decrement, as appropriate, and accounted for in accordance with the provisions of Statement of Accounting Standards AAS 10 "Accounting for the Revaluation of Non-Current Assets".

Hedging of Foreign Currency Commitments

26 The risks associated with changes in exchange rates may be limited by entering into hedging transactions. These transactions may involve foreign currency contracts (for example, forward contracts, hedge contracts, futures contracts and foreign currency options) or other foreign currency transactions (for example, borrowing in a currency in which a matching receivable is held). Hedging transactions can be classified between those relating to specific commitments (refer to paragraph 27) and those designed to cover overall net actual or anticipated foreign currency exposures (or some proportion thereof).

27 Hedges of specific commitments include those relating to the establishment of:

(a) the price of goods or services to be purchased or sold;

(b) the number of units of currency (for example, units of the domestic currency) to be paid or received in respect of a foreign currency payable or receivable; and, on occasions,

(c) the number of units of currency (for example, units of the domestic currency) committed to the net investment in a self-sustaining foreign operation.

Under this Part a hedge transaction can only be treated as a hedge of a specific commitment so long as it is expected that it will continue to be effective. Where a transaction is undertaken with the objective of hedging a specific commitment, or, where subsequent to a transaction taking place it is deemed to be a hedge of a specific commitment, it would be expected that the reporting entity would, at the time the hedge is considered to have occurred, specifically designate the transaction as such by making a formal record of the designation in the reporting entity's records.

28 With the exception of hedge transactions of the type contemplated in paragraph 27(a), any exchange differences arising on hedge transactions (whether they relate to specific commitments or otherwise) ought to be recognised in the profit and loss account or its equivalent in the period in which they arise (that is, when the relevant exchange rates change). Any costs or gains arising at the time of entering into hedge transactions, including in the case of a foreign currency contract any cost or gain resulting from a discount or premium, ought to be accounted for separately from the exchange differences on the hedge transactions and, except where the transactions are of the type referred to in paragraph 27(a), ought to be recognised in the profit and loss account or its equivalent over the lives of the hedge transactions.

Specific commitments

29 Where a hedge transaction of the type referred to in paragraph 27(a) occurs, the gain or loss on that hedging transaction up to the date of purchase or sale, and any costs or gains arising at the time of entering into that transaction, need to be deferred and included in the measurement of the purchase or sale transaction. For example, a gain on a foreign currency contract undertaken to fix the domestic price of a piece of equipment, say at the price current at the time of order, would need to be deferred and offset against the translated price of the equipment at the time of acquisition. If the hedging transaction extends beyond the time of purchase or sale, paragraph 30 will apply since it will be a monetary item that is then being hedged. This is illustrated in Appendix 2.

30 Where a foreign currency monetary item is hedged by a foreign currency contract or other foreign currency monetary asset or liability, gains or losses on the hedging item will be calculated by reference to movements in spot rates. At the same time, gains or losses on the foreign currency monetary item will be calculated in the same way (refer to paragraphs 11 and 12). Gains and losses will then be matched period by period.

31 A further manner in which a foreign currency monetary item might be hedged is by swapping or exchanging repayment schedules with another party. This will usually involve the reporting entity in an arrangement cost and will either effectively change the foreign currency in which exposure to exchange rate changes will occur or, if the swap leads to adoption of a domestic currency repayment schedule, elimination of such exposure. A contingency may exist in respect of the original repayment schedule in the event of a default. Once a swap is in place the reporting entity will need to account for

exchange gains or losses (if any) on the adopted monetary item (in the normal manner, as set out in paragraphs 9 to 13) and to bring the arrangement cost to account by deferral and amortisation to the profit and loss account or its equivalent over the life of that adopted item.

32 If a hedge transaction is entered into in relation to the net investment in a self-sustaining foreign operation [that is, paragraph 27(c)], gains or losses on the hedge would be accounted for in the normal manner, as set out in paragraphs 9 to 12, and then, to the extent that the net investment is hedged, would be transferred, on consolidation, to the foreign currency translation reserve. The effect of this will be to offset, in the consolidated financial statements, the exchange differences on the hedge transaction against the exchange differences arising from the translation of the financial statements of the foreign operation.

33 Entities may choose to borrow in a currency in which they will have foreign currency revenue available from which to meet instalments and/or settlement of that borrowing. On occasions they may be able to arrange foreign currency revenue to be available for an existing commitment in that currency. The view taken in this Part is that where entities match cash flows in this manner they still ought to account separately for the revenue and any exchange gains or losses on the commitment, so as not to obscure the effects of different transactions undertaken for different reasons (albeit that possible foreign currency implications of both transactions have been linked).

Other Specific Issues

Net investment

34 In relation to a self-sustaining foreign operation, it is to be noted that the definition of "net investment" [paragraph 3(1)] includes "any long-term intra-group balances related to the acquisition or financing of that operation". Exchange differences arising on such balances need to be accounted for in the normal manner, as set out in paragraphs 9 to 12, and then transferred, on consolidation, to the foreign currency translation reserve. This is because the intra-group balances involved are of the nature of equity finance.

Hyper-inflationary economies

35 Where an economy suffers from hyper-inflation, application of the current rate method to foreign operations located in that economy may cause difficulties. It is possible for the significance of those operations not to be reflected by their translated financial

statements. This problem can be offset to some degree by revaluing non-monetary, non-current assets in the foreign operation's financial statements prior to their translation.

Foreign investments accounted for by the equity method

36 Where an investment in a foreign associated company is accounted for by the equity method, the financial statements of that company would need to be translated into domestic currency terms, in accordance with this Part, prior to application of the equity method.

Differing balance dates

37 When the financial statements of a foreign operation are prepared as at a date which differs from the balance date of the reporting entity, the "current rate" to be used to translate those statements (or parts thereof) is the rate in effect at the reporting entity's balance date.

Minority interests

38 Any minority interests in a foreign subsidiary would need to be calculated after the subsidiary's financial statements have been translated.

Temporal method — recoverable amount

39 Where the temporal method is employed, non-monetary assets will be translated at historical rates. There may be instances where the translated carrying amount of an asset exceeds its translated recoverable amount. For example, inventories translated at historical exchange rates may exceed their foreign currency net realisable value translated at the current rate at balance date. If so, a write-down will need to be recognised in the translated financial statements. This could occur in spite of the recoverable amount of the asset exceeding its carrying amount in the foreign currency financial statements. It is also possible that a write-down could have occurred in the foreign currency financial statements which will need to be reversed in the translated statements.

Statement of sources and applications of funds

40 When a foreign operation prepares a statement of sources and applications of funds, and that statement is to be incorporated in a similar statement for the reporting entity, the exchange rates to be employed are those which have been used to translate corresponding or related amounts in the balance sheet and profit and loss or other operating statement.

Use of averages or other methods of approximation

41 This Part concentrates on specifying the rates relevant to various aspects of translation. Average or standard rates that approximate the relevant rates may well be employed for practical reasons. This will be a matter for judgment by management and will involve considerations of materiality.

Disclosures in the Financial Statements

42 Paragraph 63 of this Part requires disclosure of some of the effects of changes in exchange rates upon the financial statements. Reporting entities are encouraged to disclose additional information to supplement these disclosures so as to enable an assessment of the overall effects of changes in exchange rates during the period on the financial statements. In particular, entities are encouraged to disclose the effects on the financial statements of the entity having received foreign currency sales revenues during the period and having undertaken foreign currency purchases during the period.

43 Paragraph 63 also requires disclosure of the domestic currency equivalents, at balance date, of long-term foreign currency monetary items, in aggregate for each foreign currency and classified according to whether they are payable or receivable within or after twelve months. This disclosure is intended to provide some indication of the exposure of the reporting entity at balance date to the risks of changes in foreign exchange rates. Reporting entities are encouraged to supplement this disclosure with an outline of any management policies applied to hedge those monetary items and other matters relevant to an assessment of that exposure. Where accounts are prepared pursuant to the Companies Act (Code), the preparers of those accounts should also have regard to the requirements of clause 60(d) of Approved Accounting Standard ASRB 1012: Foreign Currency Translation. That sub-clause states:

> ".60 Where the information is material, the accounts and group accounts shall disclose —
>
> (d) separately as at balance date in aggregate for each foreign currency the amounts payable or receivable in a foreign currency in the case of -
>
> (i) current assets and current liabilities, to the extent that they are not effectively hedged; and
>
> (ii) non-current assets and non-current liabilities, to the extent that they are not effectively hedged to a date at least twelve months after balance date."

The requirements of that sub-clause are not a requirement of this Part.

Speculative Dealing

44 Speculative dealing is defined as activity undertaken solely for the purpose of gaining through movements in foreign exchange rates [refer to paragraph 3(p)]. This is to be contrasted with hedging, which is undertaken with a view to mitigating existing or anticipated exposures, and with other transactions such as purchasing, selling or raising finance which are undertaken for the other operating purposes of reporting entities. It is recognised that some transactions will have dual purposes (that is, partially to hedge and partially to speculate) and that some allocations may be necessary. For those entities engaged in speculative dealing, paragraph 63 of this Part requires disclosure of the methods used in translating the transactions involved (for example, whether resulting monetary balances and gains or losses have been determined by reference to movements in forward rates) and the net gain or loss on such dealing taken to the profit and loss account or its equivalent for the period.

ACCOUNTING STANDARDS

Discussion and Definitions

45 **The following standards shall be interpreted in the context of paragraphs 1 to 44 of this Part.**

46 **Paragraph 3 (Definitions) shall be read as forming part of the accounting standards set out in this Part.**

Materiality

47 **The accounting standards contained in paragraphs 48 to 68 shall, in accordance with Statements of Accounting Standards AAS 5 "Materiality in Financial Statements", apply to financial statements where such application is of material consequence.**

Translation of Foreign Currency Transactions

48 **At the date as at which a foreign currency transaction is recognised, each asset, liability, revenue or expense arising from the transaction shall initially be measured and recorded in the domestic currency using the exchange rate in effect at that date.**

49 **Foreign currency monetary items outstanding at balance date shall be translated at the spot rate current at that time.**

50 **Exchange differences relating to foreign currency monetary items shall be recognised in the profit and loss account or its equivalent, in the period in which they arise (that is, when the exchange rates change), as exchange gains or losses, except where paragraph 51 or 61 applies.**

51 **Exchange differences arising in respect of foreign currency monetary items which relate directly to or can be reasonably attributed to qualifying assets shall be included in the cost of acquisition of those assets, but only to the extent that they arise before the assets cease to be qualifying assets. Exchange differences shall not be included in the cost of acquisition of any other assets, except where paragraph 61 applies.**

52 **Exchange differences relating to foreign currency monetary items forming part of the net investment in a self-sustaining foreign operation shall be accounted for in accordance with paragraphs 48 to 50 and then transferred, on consolidation, to a reserve designate "foreign currency translation reserve".**

Translation of Foreign Currency Financial Statements

53 **Where a foreign operation is self-sustaining, its financial statements shall be translated at balance date using the current rate method. Any resulting exchange differences shall be recognised by an entry made directly to the foreign currency translation reserve.**

54 **Where a foreign operation is integrated with the reporting entity, its financial statements shall be translated using the temporal method. Any exchange differences arising from translation of foreign currency monetary items shall be recognised in the same manner as specified in paragraph 50.**

55 **Where, in relation to an integrated foreign operation, the translated carrying amount of a non-monetary asset exceeds its translated recoverable amount, the excess shall be recognised:**

(a) **as a revaluation decrement, in accordance with the provisions of Statement of Accounting Standards AAS 10 "Accounting for the Revaluation of Non-Current Assets"; or,**

(b) **as a write-down of a current non-monetary asset;**

as appropriate.

56 **When a foreign operation ceases to be an integrated foreign operation, and the current rate method is to be applied instead**

of the temporal method, exchange differences arising from translating non-monetary assets and liabilities at the current rate rather than at historical rates shall be taken directly to the foreign currency translation reserve.

57 **When a foreign operation ceases to be a self-sustaining foreign operation, and the temporal method is to be applied instead of the current rate method, the translated amounts of non-monetary assets at the last balance date shall be regarded as the costs of those assets for the purposes of applying the temporal method.**

Hedging of Foreign Currency Commitments

58 **Exchange differences on hedge transactions undertaken to hedge foreign currency commitments shall, except where paragraph 61 applies, be recognised in the profit and loss account or its equivalent in the period in which they arise (that is, when exchange rates change). Any costs or gains arising at the time of entering into hedge transactions shall be accounted for separately from the exchange differences on the hedge transactions and, except where paragraph 61 applies, be recognised in the profit and loss account or its equivalent over the lives of the hedge transactions.**

59 **Exchange differences on hedge transactions in the form of foreign currency contracts or other foreign currency monetary assets or liabilities shall be calculated in the same manner as for foreign currency monetary items in general. Such exchange differences shall be calculated by translating the foreign currency amount of the transaction at the spot rate current at the balance date, or, where the hedge transaction is settled during the accounting period, at the date of settlement, and by comparing the resulting amount with that same foreign currency amount translated at the date on which the transaction took place (or, if later, the last balance date).**

Specific commitments

60 **A transaction shall only be classified as a hedge of a specific foreign currency commitment so long as it is expected that it will continue to be effective.**

61 **In respect of hedge transactions intended to hedge the purchase or sale of goods or services:**

(a) exchange differences, to the extent that they occur up to the date of purchase or sale; and,

(b) costs or gains arising at the time of entering into the hedge transactions;

shall be deferred and included in the measurement of the purchase or sale.

62 **Exchange differences on transactions which hedge a net investment in a self-sustaining foreign operation shall be accounted for in accordance with paragraphs 48 to 50 and then, to the extent that the net investment is hedged, be transferred, on consolidation, to the foreign currency translation reserve.**

Disclosures in the Financial Statements

63 **The financial statements shall disclose:**

(a) the methods used in translating foreign currency transactions, including any speculative transactions, and in translating the financial statements of foreign operations;

(b) the net exchange gain or loss taken to the profit and loss account or its equivalent for the period, showing separately the net exchange gain or loss resulting from speculative dealing;

(c) a reconciliation of the opening and closing balance of the foreign currency translation reserve, detailing the nature and amount of any movements in the reserve which have occurred during the period; and,

(d) the domestic currency equivalents at balance date of long-term foreign currency monetary items, in aggregate for each foreign currency, and separated into amounts payable and receivable:

(i) twelve months or less from balance date; and,

(ii) more than twelve months from balance date.

Transitional Provisions

Translation of foreign currency transactions

64 **The provisions of this Part shall be applied retrospectively, except that where exchange differences have already been recognised in the profit and loss account or its equivalent those differences shall remain unadjusted in retained profits or**

accumulated losses. Any consequential adjustments resulting from retrospective application which, had this Part previously been applied, would have been taken to the profit and loss account or its equivalent, shall be taken to retained profits or accumulated losses at the beginning of the first period in which this Part applied.

Qualifying assets

65 **Any deferred exchange differences existing in the balance sheet at the beginning of the first accounting period to which this Part is applied which, had this Part previously been applied, would have been accounted for in accordance with paragraph 51, shall be so treated.**

Translation of foreign currency financial statements

66 **When the current rate method is to be employed, when previously it either has not been applied or it has been applied in a different manner than now required:**

(a) any deferred exchange differences existing in the balance sheet at the commencement of the first accounting period to which this Part is applied which, had this Part previously been applied, would have been taken to the profit and loss account or its equivalent, shall be taken to retained profits or accumulated losses as at that date;

(b) any deferred exchange differences existing in the balance sheet at the commencement of the first accounting period to which this Part is applied which, had this Part previously been applied, would have been taken directly to the foreign currency translation reserve, shall be taken directly to that reserve as at that date; and,

(c) exchange differences arising from translating non-monetary assets and liabilities at the current rate at balance date rather than at historical rates shall be taken directly to the foreign currency translation reserve.

67 **Where application of this Part would require the temporal method to be employed, when previously it either has not been applied or it has been applied in a different manner than now required, it shall be applied in the manner set down in paragraph 57.**

Disclosures

68 **The financial statements shall disclose adjustments made pursuant to paragraph 64, 65 or 66(a) in relation to:**

(i) retained profits or accumulated losses; and,

(ii) qualifying assets.

Applicability and Operative Date

69 **[Refer to cover sheet to this Part]**

COMPATIBILITY WITH INTERNATIONAL ACCOUNTING STANDARD IAS 21

The standards set out in this Part are consistent with those set out in IAS 21 "Accounting for the Effects of Changes in Foreign Exchange Rates", except that:

(a) whereas this Part requires disclosures relating to the net foreign currency gain or loss for the period, IAS 21 requires disclosure only of that part of the gain or loss resulting from integrated foreign operations; and,

(b) IAS 21 permits "exchange differences resulting from a severe devaluation or from depreciation of a currency against which there is no practical means of hedging and that affects liabilities arising directly on the acquisition of assets invoiced in a foreign currency" to be included in the cost of the related assets (subject to the recoverable amount constraint). This Part requires capitalisation of exchange differences in specific instances (e.g. in relation to the acquisition of qualifying assets), but does not include a permissive clause such as that cited from IAS 21.

The Councils of The Institute of Chartered Accountants in Australia and the Australian Society of Accountants have decided that, in respect of (a) above, the significance of foreign exchange gains and losses is such as to require separate disclosure and that the gains and losses resulting from integrated foreign operations are of the same nature as those resulting from the reporting entity's other foreign currency transactions and, therefore, do not need to be distinguished.

In respect of (b) above, the Councils have decided that a permissive clause allowing capitalisation of exchange differences in circumstances beyond those specified in this Part would be inappropriate.

APPENDIX 1

TRANSLATION OF FINANCIAL STATEMENTS OF FOREIGN OPERATIONS

INTRODUCTION

This Appendix, which does not form part of the accounting standards set out in this Part, illustrates the translation of the financial statements of a foreign operation when it is:

(a) an integrated foreign operation; and,

(b) a self-sustaining foreign operation.

DATA

Investor Company Ltd. formed Subsidiary Company Ltd., a foreign operation, on 30 June 19X0. It subscribed the issued capital of $FC100,000 and raised a further $FC200,000 in the form of a 5 year loan (repayable in 5 equal annual instalments on 30 June of each year). Fixed assets of $FC201,701 were also acquired on 30 June 19X0.

At 30 June 19X0 the translation of the balance sheet of Subsidiary Company would be performed in the same manner under either the temporal method (used for integrated foreign operations) or the current rate method (used for self-sustaining foreign operations). This is because exchange rates had not changed (i.e. historical and current rates were the same at that time).

The exchange rates relevant to translating Subsidiary Company's financial statements were as follows:

30 JUNE 19X0 $FC1.0 = $A1.7

30 JUNE 19X1 $FC1.0 = $A2.0

During the year to 30 June 19X1 a representative average exchange rate was $FC1.0 = $A1.8. Inventory on hand at the end of that period was acquired when the exchange rate was $FC1.0 = $A1.95.

As there had been no transaction affecting the profit and loss statement by 30 June 19X0, only the balance sheet is dealt with below.

SUBSIDIARY COMPANY

BALANCE SHEET AS AT 30 JUNE 19X0

	$FC	*Exchange Rate*	*$A*
SHARE CAPITAL & RESERVES			
Paid-up Capital	100,000	1.70	170,000
CURRENT LIABILITIES			
Loan	40,000	1.70	68,000
NON-CURRENT LIABILITIES			
Loan	160,000	1.70	272,000
Total Liabilities	200,000		340,000
TOTAL	$300,000		$510,000
CURRENT ASSETS			
Cash	98,299	1.70	167,108
NON-CURRENT ASSETS			
Plant & Equipment	70,550	1.70	119,935
Land	21,111	1.70	35,889
Buildings	110,040	1.70	187,068
	201,701		342,892
TOTAL	$300,000		$510,000

At 30 June 19X0, Investor Company would have consolidated the above balance sheet, under either the temporal or the current rate method, by simply eliminating the issued capital of Subsidiary Company against its investment in that company and aggregating all remaining line items (this is demonstrated below for the following year).

YEAR ENDED 30 JUNE 19X1

The consolidation worksheets for the two companies are shown in Schedule 1 (integrated foreign operation) and Schedule 2 (self-sustaining foreign operation) for the period ending 30 June 19X1.

APPENDIX 1 (*cont.*)

SCHEDULE 1

INTEGRATED FOREIGN OPERATION

BALANCE SHEETS AS AT 30 JUNE 19X1

	Investor Coy. $A	*Subsidiary Coy. $FC*	*Exchange Rate*	*Subsidiary Coy. $A*	*Adjustment DR*	*Adjustment CR*	*Consolidated $A*
SHARE CAPITAL & RESERVES							
Paid-up Capital	850,000	100,000	1.70	170,000	170,000		850,000
Retained Profits	675,000	59,538	See P&L	87,983			762,983
Total	1,525,000	159,538		257,983			1,612,983
CURRENT LIABILITIES							
Trade Creditors	5,675	28,900	2.00	57,800			63,475
Provision for Income Tax	195,314	50,717	2.00	101,434			296,748
Loan	-	40,000	2.00	80,000			80,000
Total	200,989	119,617		239,234			440,223
NON-CURRENT LIABILITIES							
Loan	300,000	120,000	2.00	240,000			540,000
Total Liabilities	500,989	239,617		479,234			980,223
TOTAL	$2,025,989	$399,155		$737,217			$2,593,206
CURRENT ASSETS							
Cash at Bank	67,589	78,011	2.00	156,022			223,611
Trade Debtors	45,000	45,000	2.00	90,000			135,000
Inventories	55,000	87,000	1.95	169,650			224,650
Total	167,589	210,011		415,672			583,261
NON-CURRENT ASSETS							
Plant & Equipment	1,150,000	63,495	1.70	107,941			1,257,941
Land	330,314	21,111	1.70	35,889			366,203
Buildings	208,086	104,538	1.70	177,715			385,801
Investment in Subsidiary	170,000	-		-		170,000	-
Total	1,858,400	189,144		321,545			2,009,945
TOTAL ASSETS	$2,025,989	$399,155		$737,217			$2,593,206

APPENDIX 1 (*cont.*)
SCHEDULE 1 (*cont.*)
INTEGRATED FOREIGN OPERATION
PROFIT AND LOSS STATEMENT FOR YEAR ENDED 30 JUNE 19X1

	Investor	*Subsidiary*	*Exchange*	*Subsidiary*	*Adjustment*		*Consolidated*
	Coy. $A	*Coy. $FC*	*Rate*	*Coy. $A*	*DR*	*CR*	*$A*
Sales	$990,000	$448,850	1.80	$807,930			$1,797,930
Less: Cost of Goods Sold							
Opening Inventory	71,000	-		-			71,000
Purchases	345,000	271,000	1.80	487,800			832,800
	416,000	271,000		487,800			903,800
Closing Inventory	55,000	87,000	1.95	169,650			224,650
	361,000	184,000		318,150			679,150
Gross Profit	629,000	264,850		489,780			1,118,780
Less: Expenses							
Administrative	34,000	62,000	1.80	111,600			145,600
Selling	45,000	80,038	1.80	144,068			189,068
Depreciation	125,404	12,557	1.70	21,347			146,751
Foreign Exchange Translation Loss	-	-	See W/S 1.1	33,491			33,491
	204,404	154,595		310,506			514,910
Operating Profit Before Income Tax	424,596	110,255		179,274			603,870
Income Tax Expense	195,314	50,717	1.80	91,291			286,605
Operating Profit	229,282	59,538		87,983			317,265
Retained Profit 1/7/X0	445,718	-		-			445,718
Retained Profit 30/6/X1	$675,000	$59,538		$87,983			$762,983

APPENDIX 1 (*cont.*)
SCHEDULE 1 (*cont.*)
INTEGRATED FOREIGN OPERATION

Introduction to Worksheets

Under the temporal method foreign exchange gains or losses will arise in respect of monetary items. They will arise where exchange rates relevant to monetary items appearing in the previous period's balance sheet change in the current period and when exchange rates used in translating those elements of the profit and loss account or its equivalent involving monetary items differ from the rates applied in the current period's balance sheet in respect of those monetary items.

WORKSHEET 1.1 — FOREIGN EXCHANGE TRANSLATION LOSS

Subsidiary Company borrowed $FC200,000 on 30/6/X0 when the exchange rate was $FC1.0 = $A1.7. The exchange rate at the end of the period, when the first instalment was paid, was $FC1.0 = $A2.0.

		$FC	*Rate*	*$A*	*$A Loss*
Loan	30/06/X0	200,000	1.70	340,000	-
	31/12/X0	200,000	1.80	360,000	20,000
	31/05/X1	200,000	1.95	390,000	30,000
	30/06/X1	200,000	2.00	400,000	10,000
A. Loss on Long-term Monetary Items					$60,000

Net monetary items other than long-term debt (covered above):

	$FC 19X0	*$FC 19X1*	
Cash	98,299	118,011	(includes loan instalment
Trade Debtors	-	45,000	$FC 40,000 paid
	98,299	163,011	30/6/19X1)
Trade Creditors	-	28,900	
Provision for Tax	-	50,717	
	-	79,617	
Net Monetary Assets	$98,299	$83,394	

INTEGRATED FOREIGN OPERATION

Gain from translating opening net monetary assets at average rate (1.8) rather than closing rate at 30 June 19X0 (1.7)

$$= 98{,}299 \times 0.1$$

9,830

Gain from translating closing net monetary assets at the closing rate at 30 June 19X1 (2.0) rather than the average rate (1.8)

$$= 83{,}394 \times 0.2$$

	16,679
B. Gain on Short-term Monetary Items	$26,509
C. Net Loss on Translation (A–B)	$33,491

APPENDIX 1 (*cont.)*
SCHEDULE 1 (*cont.*)
INTEGRATED FOREIGN OPERATION

WORKSHEET 1.2 – DEPRECIATION

	$FC Cost	*Depreciation Rate*	*$FC Depreciation*	*$FC WDV*
ASSET $FC				
Plant & Equipment	70,550	0.10	7,055	63,495
Buildings	110,040	0.05	5,502	104,538
	$180,590		$12,557	$168,033

	$FC Cost	*Historical Exchange Rate*	*$A Cost*	*Depreciation Rate*	*$A Depreciation*	*$A WDV*
ASSET $A						
Plant & Equipment	70,550	1.70	119,935	0.10	11,994	107,941
Buildings	110,040	1.70	187,068	0.05	9,353	177,715
	$180,590		$307,033		$21,347	$285,656

APPENDIX 1 (*cont.*)

SCHEDULE 2

SELF-SUSTAINING FOREIGN OPERATION

BALANCE SHEETS AS AT 30 JUNE 19X1

	Investor Coy. $A	*Subsidiary Coy. $FC*	*Exchange Rate*	*Subsidiary Coy. $A*	*Adjustment DR*	*Adjustment CR*	*Consolidated $A*
SHARE CAPITAL & RESERVES							
Paid-up Capital	850,000	100,000	1.70	170,000	170,000		850,000
Foreign Currency Translation Reserve	-	-	See W/S 2.1	28,858			28,858
Retained Profits	675,000	59,538	See P&L	120,218			795,218
Total	1,525,000	159,538		319,076			1,674,076
CURRENT LIABILITIES							
Trade Creditors	5,675	28,900	2.00	57,800			63,475
Provision for Income Tax	195,314	50,717	2.00	101,434			296,748
Loan	-	40,000	2.00	80,000			80,000
Total	200,989	119,617		239,234			440,223
NON-CURRENT LIABILITIES							
Loan	300,000	120,000	2.00	240,000			540,000
Total Liabilities	500,989	239,617		479,234			980,223
TOTAL	$2,025,989	$399,155		$798,310			$2,654,299
CURRENT ASSETS							
Cash at Bank	67,589	78,011	2.00	156,022			223,611
Trade Debtors	45,000	45,000	2.00	90,000			135,000
Inventories	55,000	87,000	2.00	174,000			229,000
Total	167,589	210,011		420,022			587,611
NON-CURRENT ASSETS							
Plant & Equipment	1,150,000	63,495	2.00	126,990			1,276,990

Land	330,314	21,111	2.00	42,222		372,536
Buildings	208,086	104,538	2.00	209,076		417,162
Investment in Subsidiary	170,000	-		-	170,000	-
Total	1,858,400	189,144		378,288		2,066,688
TOTAL ASSETS	$2,025,989	$399,155		$798,310		$2,654,299

APPENDIX 1 (*cont.*)

SCHEDULE 2 (*cont.*)
SELF-SUSTAINING FOREIGN OPERATION
PROFIT AND LOSS STATEMENT FOR YEAR ENDED 30 JUNE 19X1

	Investor Coy. $A	*Subsidiary Coy. $FC*	*Exchange Rate*	*Subsidiary Coy. $A*	*Adjustment DR*	*Adjustment CR*	*Consolidated $A*
Sales	$990,000	$448,850	1.80	$807,930			$1,797,930
Less: Cost of Goods Sold							
Opening Inventory	71,000	-		-			71,000
Purchases	345,000	271,000	1.80	487,800			832,800
	416,000	271,000		487,800			903,800
Closing Inventory	55,000	87,000	1.95	169,650			224,650
	361,000	184,000		318,150			679,150
Gross Profit	629,000	264,850		489,780			1,118,780
Less: Expenses							
Administrative	34,000	62,000	1.80	111,600			145,600
Selling	45,000	80,038	1.80	144,068			189,068
Depreciation	125,404	12,557	1.80	22,603			148,007
	204,404	154,595		278,271			482,675
Operating Profit Before Income Tax	424,596	110,255		211,509			636,105
Income Tax Expense	195,314	50,717	1.80	91,291			286,605
Operating Profit	229,282	59,538		120,218			349,500
Retained Profit 1/7/X0	445,718	-		-			445,718
Retained Profit 30/6/X1	$675,000	$59,538		$120,218			$795,218

APPENDIX 1 (*cont.*)

SCHEDULE 2 (*cont.*)

SELF-SUSTAINING FOREIGN OPERATION

Introduction to Worksheets

Exchange differences arise under the current rate method whenever the exchange rate employed in translating the balance sheet at the end of a period differs from that employed for the previous period's balance sheet and/or from the rate/s employed in translating the current period's profit and loss or other operating statement.

WORKSHEET 2.1 — MOVEMENT IN FOREIGN CURRENCY TRANSLATION RESERVE

Opening Net Assets	$FC100,000	
× Change in exchange rate		
$FC1.0 = $A1.7/$FC1.0 = $A2.0	0.30	30,000
Change in Net Assets	$FC59,538	
× $FC1.0 = $A2.0	119,076	
Per Profit and Loss Statement	120,218	
		(1,142)
Total Movement		$A23,858

WORKSHEET 2.2 — DEPRECIATION

	$FC Cost	*Depreciation Rate*	*$FC Depreciation*	*$FC WDV*
ASSET $FC				
Plant & Equipment	70,550	0.10	7,055	63,495
Buildings	110,040	0.05	5,502	104,538
	$180,590		$12,557	$168,033

	$FC Cost	*Current Exchange Rate*	*$A Cost*	*Depreciation Rate*	*$A Depreciation*	*$A WDV*
ASSET $A						
Plant & Equipment	70,550	2.00	141,100	0.10	14,110	126,990
Buildings	110,040	2.00	220,080	0.05	11,004	209,076
	$180,590		$361,180		$25,114	$336,066

Note that in the profit and loss statement the depreciation charge has been translated at the average rate (1.8) rather than the closing rate (2.0) used in the above worksheet.

APPENDIX 2

ACCOUNTING FOR FOREIGN CURRENCY CONTRACTS

INTRODUCTION

This Appendix illustrates the calculations underlying the reporting requirements of this Part in relation to foreign currency contracts. The Appendix does not form part of the accounting standards set out in this Part.

DATA

Importer Company Ltd. on 30 April 19X0 purchased inventories costing $FC95,000 on trade credit. Payment was due in 3 months (i.e. on 31 July 19X0). At the time of purchase the following exchange rate (the spot rate) applied:

$FC1 = $A1 *(Spot Rate 30 April 19X0)*

On 30 June 19X0, Importer Company Ltd.'s reporting date, the following spot rate applied:

$FC1 = $A1.10 *(Spot Rate 30 June 19X0)*

When the creditor was paid for his goods on 31 July 19X0 the rate had moved to:

$FC1 = $A1.12 *(Spot Rate 31 July 19X0)*

JOURNAL ENTRIES FOR PURCHASE OF INVENTORIES

If the above purchase were made on an unhedged basis the following entries would apply:

		Dr.	Cr.
30 April 19X0	Inventories	95,000	
	Trade Creditor		95,000
	(Purchase of inventories costing $FC95,000 when the spot rate was $FC1 = $A1)		
30 June 19X0	Foreign Currency Exchange Loss	9,500	
	Trade Creditor		9,500
	(Recognition of foreign exchange loss on trade credit outstanding ($FC95,000) when the spot rate moved from $FC1 = $A1 to $FC1 = $A1.10)		

31 July 19X0	Foreign Currency Exchange Loss Trade Creditor (Recognition of further foreign exchange loss on trade credit outstanding when the spot rate moved from $FC1 = $A1.10 to $FC1 = $A1.12)	1,900	 1,900
31 July 19X0	Trade Creditor Cash at Bank (Payment of Trade Creditor)	106,400	 106,400

FOREIGN CURRENCY CONTRACT

Importer Company may have entered into a foreign currency contract to hedge the above specific commitment. It may have entered into that contract to:

(a) determine the purchase price of the inventories; or,

(b) limit its exposure to exchange rate movements in respect of the liability to the trade creditor.

FURTHER DATA

At the time of ordering the inventories on 31 march 19X0 Importer Company was given a firm price of $FC95,000 (when the spot rate was $FC1 = $A0.95). Importer Company was concerned to limit its exposure to exchange rate movements. Accordingly, it entered into a foreign currency contract (at a forward rate of $FC1 = $A0.97) on 31 March for the purchase of $FC95,000 for delivery on 31 July 19X0.

CALCULATIONS

Cost of Entering Foreign Currency Contract

(a) At time of entry

- spot rate $FC1 = $A0.95
- forward rate $FC1 = $A0.97

Note: This assumes direct quotation of the exchange rates. Refer to definition of premium, paragraph 3(b).

(b) Number of units of foreign currency to be purchased

- $FC95,000

APPENDIX 2 (*cont.*)

(c) Cost of contract

- $FC95,000 × 0.02
- <u>$A1,900</u>

Note**:** Under paragraph 61 of this Part this cost would be deferred and included in the cost of the related inventories.

Calculation of Exchange Gains on Foreign Currency Contract

(a) At 30 April 19X0

- spot rate at 31 March 19X0 $FC1 = $A0.95
- spot rate at 30 April 19X0 $FC1 = $A1.00

(b) Gain on contract to 30 April 19X0

- $FC95,00 × 0.05
- <u>$A4,750</u>

Note: Under paragraph 61 of this Part this gain would form part of the net cost of the related inventories.

(c) At 30 June 19X0 the spot rate had moved to $FC1 = $A1.10

(d) Gain on contract from 30 April to 30 June 19X0

- $FC95,000 × 0.10
- <u>$A9,500</u>

Note**:** Under paragraph 58 of this Part this gain on the foreign currency contract would be credited to the profit and loss account. However, it would be offset by an equivalent loss on the underlying transaction (i.e. the purchase). The trade creditor would have been raised at 30 April ($FC95,000 × 1.0 = $A95,000) and at 30 June would have needed restating to $FC95,000 × 1.1 = $A104,500 (yielding a loss of $A9,500).

(e) Gain on contract from 30 June to 31 July 19X0

- $FC95,000 × 0.02 ($FC1 = $A1.10/$FC1 = $A1.12)
- <u>$A1,900</u>

Note**:** As for (d) above. Would be a gain offset by equivalent loss on trade creditor of $A1,900.

APPENDIX 2 (*cont.*)

SUMMARY

(a) Unhedged Purchase

- Inventories brought to account at $A95,000 ($FC95,000 × 1.0)
- Foreign exchange loss (P & L) $A9,500

(b) Hedged Purchase

- Inventories brought to account at $A92,150 ($A95,000 plus $A1,900 for cost of entering contract, less $A4,750 gain on contract to 30 April 19X0)
- Gains and losses taken to the P & L would offset each other completely.

COMMENTARY

It should be noted that under the hedged purchase the cost arising at the time of entering into the foreign currency contract (that is, resulting from the premium of $A0.02), together with the gain arising under the contract up until the purchase, were included in the measurement of the cost of the inventories.

Subsequently, the foreign currency contract was hedging a foreign currency liability. Gains under the contract offset losses on the trade creditor.

HEDGING NET EXPOSURE

If the foreign currency contract illustrated above had been for hedging a net foreign currency exposure, the only difference in accounting for the contract would have been that the gain derived prior to the acquisition of the inventories, and the cost arising at the time of entering into the contract, would have been taken to the profit and loss account. The gain would have been immediately credited to that account and the cost would have been deferred in the balance sheet and amortised to the profit and loss account over the four-month life of the foreign currency contract.