(Section 2)

International Accounting

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Chapter 7

Foreign Currency Transactions and Hedging Foreign Exchange Risk

Exercises and Problems

4. C The 100,000 shekel receivable has changed in dollar value from $24,000 at 12/1/Y1 to $22,000 at 12/31/Y1. The shekel receivable will be written down by $2,000 and a foreign exchange loss will be reported in Year 1 income.

5. D The nominal value of the forward contract on December 31, Year 1 is a positive $3,000, the difference between the amount to be received from the forward contract actually entered into, $23,000 ($.23 x 100,000 shekels), and the amount that could be received by entering into a forward contract on December 31, Year 1 that matures on January 15, Year 2, $20,000 ($.10 x 100,000 shekels). The fair value of the forward contract is the present value of $3,000 discounted for two months ($3,000 x .9706 = $2,911.80). On December 31, Year 1, Reiter Corp. will recognize a $2,911.80 gain on the forward contract and a foreign exchange loss of $2,000 on the shekel receivable. The net impact on Year 1 income is + $911.80.

15. Budvar Company (Second Problem)

a. Forward Contract Cash Flow Hedge of Foreign Currency Payable

12/1/Y1	Inventory	$20,000	
	Accounts payable (crown) [20,000 x $1.00]		$20,000
	No entry for the forward contract.		
12/31/Y1	Foreign exchange loss	$1,000	
	Accounts payable (crown) [20,000 x ($1.05-$1.00)]		$1,000
	AOCI	$1,000	
	Gain on forward contract		$1,000
	Forward contract	$1,176.36	
	AOCI [20,000 x ($1.04-$1.10) = $1,200 x .9803 = $1,176.36]		$1,176.36
	Premium expense	$266.67	
	AOCI [20,000 x ($1.04-$1.00) = $800 x 1/3 = $266.67]		$266.67

Impact on Year 1 income:

Foreign exchange loss	$(1,000.00)
Gain on forward contract	1,000.00
Premium expense	(266.67)
Total	$ (266.67)

3/1/Y2	Foreign exchange loss	$1,400	
	Accounts payable (crown) [20,000 x ($1.12-$1.05)]		$1,400
	AOCI	$1,400	
	Gain on forward contract		$1,400
	Forward contract [20,000 x ($1.12-$1.04) = $1,600 – 1,176.36]	$423.64	
	AOCI		$423.64
	Premium expense	$533.33	
	AOCI [$800 x 2/3 = $533.33]		$533.33
	Foreign currency (crown) [20,000 x $1.12]	$22,400	
	Cash [20,000 x $1.04]		$20,800
	Forward contract		1,600
	Accounts payable (crown)	$22,400	
	Foreign currency (crown)		$22,400
3/15/Y2	Cost of goods sold	$20,000	
	Inventory		$20,000

Impact on Year 2 income:

Foreign exchange loss	$(1,400.00)
Gain on forward contract	1,400.00
Premium expense	(533.33)
Cost of goods sold	(20,000.00)
Total	$(20,533.33)

Impact on net income over both periods: $(266.67) + ($20,533.33) = $20,800; equal to cash outflow.

b. Forward Contract Fair Value Hedge of Foreign Currency Payable

12/1/Y1	Inventory	$20,000	
	Accounts payable (crown) [20,000 x $1.00]		$20,000

No entry for the forward contract.

12/31/Y1	Foreign exchange loss	$1,000	
	Accounts payable (crown) [20,000 x ($1.05-$1.00)]		$1,000
	Forward contract	$1,176.36	
	Gain on forward contract		$1,176.36
	[20,000 x ($1.04-$1.10) = $1,200 x .9803 = $1,176.36]		

Impact on Year 1 income:

Foreign exchange loss	$(1,000.00)
Gain on forward contract	1,176.36
Total	$ 176.36

3/1/Y2	Foreign exchange loss	$1,400	
	Accounts payable (crown) [20,000 x ($1.12-$1.05)]		$1,400
	Forward contract	$423.64	
	Gain on forward contract		$423.64
	[20,000 x ($1.12-$1.04) = $1,600 – 1,176.36]		
	Foreign currency (crown) [20,000 x $1.12]	$22,400	
	Cash [20,000 x $1.04]		$20,800
	Forward contract		1,600
	Accounts payable (crown)	$22,400	
	Foreign currency (crown)		$22,400
3/15/Y2	Cost of goods sold	$20,000	
	Inventory		$20,000

Impact on Year 2 income:

Foreign exchange loss	$(1,400.00)
Gain on forward contract	423.64
Cost of goods sold	(20,000.00)
Total	$(20,976.36)

Impact on net income over both periods: $176.36 + ($20,976.36) = $20,800; equal to cash outflow.

18. Butterworth Company

a. Forward Contract Fair Value Hedge of Foreign Currency Receivable

10/01/Y1	Accounts Receivable (rupees) [$.069 x 100,000]	$6,900	
	Sales		$6,900
	There is no formal entry for the forward contract.		
12/31/Y1	Account Receivable (rupees)	$200	
	Foreign Exchange Gain [($.071 - $.069) x 100,000]		$200
	Loss on Forward Contract	$891.09	
	Forward Contract		$891.09
	[($.074 - $.065) x 100,000 = $ 900 x .9901 = $ 891.09]		
1/31/Y2	Accounts Receivable (rupees)	$100	
	Foreign Exchange Gain [($.072 - $.071) x 100,000]		$100

	Forward Contract	$191.09	
	Gain on Forward Contract		$191.09
	[($.072 - $.065) x 100,000 = $ 700 loss - $891.09 = $ 191.09 gain]		
	Foreign Currency (rupees) [$.072 x 100,000]	$7,200	
	Accounts Receivable (rupees)		$7,200
	Cash	$6,500	
	Forward Contract	700	
	Foreign Currency (rupees)		$7,200

The impact on net income:

Sale	$6,900.00
Foreign Exchange Gain	300.00
Loss on Forward Contract	(891.09)
Gain on Forward Contract	<u>191.09</u>
Impact on net income	$6,500.00 = Cash Inflow

b. Forward Contract Fair Value Hedge of Foreign Currency Firm Sales Commitment

10/01/Y1 There is no entry to record either the sales agreement or the forward contract as both are executory contracts.

12/31/Y1	Loss on Forward Contract	$891.09	
	Forward Contract		$891.09
	Firm Commitment	$891.09	
	Gain on Firm Commitment		$891.09
1/31/Y2	Forward Contract	$191.09	
	Gain on Forward Contract		$191.09
	Loss on Firm Commitment	$191.09	
	Firm Commitment		$191.09
	Foreign Currency (rupees)	$7,200	
	Sales		$7,200
	Cash	$6,500	
	Forward contract	700	
	Foreign Currency (LCU)		$7,200
	Adjustment to Net Income	$700	
	Firm Commitment		$700

Impact on Net Income:

Sales	$7,200	
Net loss on Forward Contract	(700)	
Net gain on Firm Commitment	700	
Adjustment for Net Income		(700)
	$6,500 = Cash Inflow	