CHAPTER 13

HOW SHOULD A BUSINESS ACCOUNT FOR TRANSACTIONS IN FOREIGN CURRENCIES?

96 BOOKS OF ACCOUNTS - A QUICK RECAP

In Chapter 3, we talked about the Books of Accounts which are normally used by a Business. The following Books of Accounts are used for Accounting of foreign currency transactions:

- General ledger
- Cash & Bank Book

In this Chapter, wherever Accounting entries are required to be shown, we will use these Books for illustration purposes.

97 WHAT ARE FOREIGN CURRENCY TRANSACTIONS?

The choice of what is a foreign currency depends on the Business's country of residence. For all Businesses based in Pakistan, Pakistan Rupee is the "base" currency while any other currency will be a foreign currency.

Because all foreign currencies have different exchange rates and because, in Pakistan, we deal in Pakistani Rupees, all transactions conducted in foreign currencies will need to be converted into Pakistani Rupees. Within Pakistan, almost all transactions get conducted in Pakistani Rupees – there are, however, two instances which are faced by almost all Businesses from time to time:

- Exports
- Imports

Pakistani Businesses can import and export from almost any country in the world which means that there will be a similar number of different foreign currencies to deal with. The only difference will be the exchange rate i.e. the rate at which the foreign currency will get converted into Pakistan Rupees – the methods and techniques that a Business will adopt to convert foreign currencies are the same.

98 UNDERSTANDING THE TERMINOLOGY

Before we go further into Accounting for foreign currencies, it is important to understand the commonly used terminology in this context:

Foreign Currency	It is the currency other than the currency of the country in which the Business is located.
Local Currency	Also called the "Base Currency", and is the currency of the country in which that Business is located.
Exchange Rate	Rate at which one currency is converted into another currency.
Translation	The process of conversion of foreign currencies into one another.
Exchange Difference	It is the difference resulting from translation of the amount of foreign currency into the Base currency on two different dates.
Exchange Gain	When exchange differences are such that more amount of base currency is in hand than before.
Exchange loss	When exchange differences are such that lesser amount of base currency is in hand than before.

99 WHAT ARE THE DIFFERENT TYPES OF FOREIGN EXCAHNGE RATES?

The major risk associated with dealing in foreign currencies is that of movement in exchange rates.

Because the movement in exchange rates is dictated by various factors occurring around the world, it is very difficult to predict the exchange rate in future. Therefore, when a Business conducts transactions in foreign currencies, it is more advisable to "lock in" to an exchange rate so that at the time that a transaction is entered into, the Business knows the exact value to be received or paid in respect of its foreign currencies.

First, we will discuss the more commonly used types of exchange rates:

99.1 SPOT RATE

Where a translation or conversion needs to be done immediately, a spot rate is used. The important requirement is that the foreign currency must be delivered at the same time in exchange for the other currency.

EXAMPLE # 13.1

Spot Rate

Hussain Khaddar & Looms (Pvt) Limited had some leftover Greige Khaddar. On 10/8/05, a customer in USA contacted him and agreed to buy all the leftover Khaddar for US$ 1,500. He sent advance payment on 15/8/05 and US dollars were received in Pakistan on 18/8/05. The exchange rate of US$ to Rs. on 18/8/05 was Rs. 60.00 / US$. Hussain Khaddar asked the Bank to make conversion on 18/8/05.

On 18/8/05, the spot rate was Rs. 60.00 / US$ because on that same day US$ 1,500 was given to the Bank and Rs. 90,000 were received there against.

99.2 FORWARD RATE

Where a conversion needs to be carried out on a date in future, the Business may want to secure itself by entering into a forward rate commitment with a Bank. In such a case, the Bank and the Business will agree on a rate today on which the transaction will be settled on the future date, this pre-agreed rate is called Forward Rate. This forward rate will be applied to the transaction irrespective of the spot rate when the transaction gets concluded.

EXAMPLE # 13.2

Forward Rate

Hanif Auto Engineering had to buy an engine part from USA. He placed an order with Abraham & Co in California on 7/5/06 for US$ 2,000 which was required to be paid on 20/5/06. The spot rate on 7/5/06 was Rs. 60.00 / US$. and the forward rate for settlement on 20/5/06 was Rs. 60.50 / US$. Hanif Auto did not want to take any risk and decided to opt for the forward rate. Spot rate on 20/5/06 was Rs. 60.25 / US$.

When payment is made on 20/5/06, Hanif Auto will bring Rs. 121,000 (US$ 2,000 @ Rs. 60.50 / US$) to the Bank, in lieu of which, the Bank will give US$ 2,000 to Hanif Autos.

99.3 BUYING RATE

The buying rate is the rate at which the Bank will buy foreign currency from a Business. There is a Spot Buying Rate and also a Forward Buying Rate.

99.4 SELLING RATE

The selling rate is the rate at which the Bank will sell foreign currency to a Business. Again, there is a Spot Selling Rate and a Forward Selling Rate.

You will note that the terminology is aimed at quoting exchange rates from a Bank's perspective e.g. the Buying Rate is the rate which Bank will buy foreign currency from a Business which, therefore, is the selling rate for the Business.

100 WHAT IS THE ACCOUNTING FOR FOREIGN CURRENCIES?

As we explained in section 2 of this Chapter, we will use export & import transactions as examples to show how foreign currencies are dealt with in Accounts. The Accounting rules are same whether it is an import or an export transaction, and these rules can be summarized as follows:

- Foreign currency transactions are recorded at the time that such transactions are entered into, e.g. sales invoice raised, purchase invoice received.
- Foreign currency transaction is worked out at the time that payments are received or paid out against such transactions.

Foreign currency transactions, if unsettled at the time that Accounts are prepared, will get re-translated. Unsettled transactions are those where, for example, a sales invoice has been raised but payment has not been received or where a purchase invoice has been received but payment has not been made.

The Accounting rules require that foreign currencies should be translated in Pak Rupees at an exchange rate which gives the fairest indication of the actual amount. The following general rule of thumb will show this:

- When a sales invoice is booked, the exchange rate to be used should be the Spot Buying Rate.
- When a purchase invoice is booked, the exchange rate should be the Spot Selling Rate.
- When the unsettled transactions are being re-translated, balances are converted at the average of the Spot Buying & Selling rates on the last day of the financial year.

Lastly, where a transaction is entered into using a Forward Rate, that same rate will be used always. For such transactions, there will be no re-translation at the end of the financial year because the exchange rate to apply in such cases will always remain same, i.e., it will be the Forward Rate.

101 WHAT IS EXCHANGE GAIN OR LOSS?

Exchange gain or loss arises whenever a transaction in foreign currency is translated between two dates. A simple example could be an export sale against which proceeds or payments have not been received till the time that accounts are being prepared.

In this case, since the transaction is unsettled i.e. balance is outstanding and in foreign currency, the balance will be re-translated. Any difference between the translated balance on the date of first recording and on subsequent re-translation is called an exchange difference. You will also recall that exchange differences can be "gains" or "losses".

The worthwhile point to note is that exchange differences only arise when exchange rates have changed – in the case of transactions booked on forward rates, there is no question of exchange differences because the translation will always be at the forward rate.

EXAMPLE # 13.3
Exchange Gain / Loss
Hussain Khaddar & Looms (Pvt) Limited exported Khaddar on 7/10/05 to UK (John Smith) valued at £ 5,000 when the rate of exchange was £ 1 = Rs. 115. Customer sent a TT for £ 5,000 on 20/10/05, at which time the exchange rate was £ 1 = Rs. 113.

On 7/10/05, when Khaddar was exported, the spot exchange rate was Rs. 115.00 / £ - a receivable of Rs. 575,000 will be recognized by Hussain Khaddar. When payment is received on 20/10/05, the spot exchange rate is £ 1 = Rs. 113 which means that the full payment translates into Rs. 565,000 i.e. an exchange loss of Rs. 10,000.

If the exchange rate had moved upwards to (say) £ 1 = Rs. 118 on 20/10/05, there would have been an exchange gain of Rs. 15,000.

102 WHAT IS THE ACCOUNTING FOR EXPORT TRANSACTIONS?

By now, we have understood the basic rules of Accounting for foreign currency transactions. We will now take examples to show how transactions are recorded.

102.1 AT A SPOT RATE AGAINST WHICH PAYMENT HAS BEEN RECEIVED

Where a Business decides to export without locking into a forward exchange rate, the following examples will show how Accounting is carried out.

EXAMPLE # 13.4
Export on Spot Rate & Payment Received
We will use Example # 13.3.

On 7/10/05, when Khaddar was exported, the rate of exchange was £ 1 = Rs. 115:

GENERAL LEDGER							
CUSTOMERS CONTROL ACCOUNT							GL-15
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
7/10/05	GL-16	Sales Account	575,000				

GENERAL LEDGER							
SALES ACCOUNT							GL-16
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				7/10/05	GL-15	Customers Control Account	575,000

And, the memorandum Sales Ledger is also updated:

SALES LEDGER					
JOHN SMITH					SL-30
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance (Rs.)
07/10/05	16	Khaddar exported for £ 5000	575,000		575,000

Remember, the inventory records will also be updated with this shipment. We have, however, not shown those Accounting entries here.

On 20/10/05, when payment is received, the exchange rate was £ 1 = Rs. 113:

GENERAL LEDGER							
BANK ACCOUNT							GL-20
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
20/10/05	GL-15	Customers Control Account	565,000				

GENERAL LEDGER							
CUSTOMERS CONTROL ACCOUNT							GL-15
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				20/10/05	GL-20	Bank Account	565,000

And, the memorandum Sales Ledger is also updated:

SALES LEDGER					
JOHN SMITH				SL-30	
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance (Rs.)
20/10/05	BRV 023/05	Payment received		565,000	10,000

On 20/10/05, John Smith's account in Sales Ledger will show a balance receivable of Rs. 10,000 even though full payment has been received. This balance represents exchange loss which has been incurred because of a change in the exchange rate. The following entry will now be recorded:

GENERAL LEDGER							
EXCHANGE GAIN / LOSS ACCOUNT							GL-50
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
20/10/05	GL-15	Customers Control Account	10,000				

GENERAL LEDGER							
CUSTOMERS CONTROL ACCOUNT							GL-15
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				20/10/05	GL-50	Exchange Gain / Loss Account	10,000

And, the memorandum Sales Ledger is also updated:

SALES LEDGER					
JOHN SMITH					SL-30
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance (Rs.)
20/10/05	JV 057/05	Exchange loss		10,000	Nil

102.2   AT A SPOT RATE AGAINST WHICH PAYMENT IS PENDING

Selling of goods on credit is a normal part of the Business. Depending on the timing of entering into the sale contract, it may be possible that payment has not been received at the time that Accounts are prepared. In such cases, Accounting rules require foreign currency balances to be re-translated on the date that Accounts are prepared.

Following example will show how it is done:

> **EXAMPLE # 13.5**
>
> **Export on Spot Rate & Payment Pending**
>
> Continuing Example # 13.3, payment was received on 20/11/05 when the exchange rate was £ 1 = Rs. 118. Hussain Khaddar is making Accounts for October '05 when exchange rate was £ 1 = Rs. 117.

On 7/10/05, when shipment was made, the Accounting entries will be same as have already been shown. These are repeated here for the sake of convenience.

GENERAL LEDGER							
CUSTOMERS CONTROL ACCOUNT							GL-15
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
7/10/05	GL-16	Sales Account	575,000				

GENERAL LEDGER							
SALES ACCOUNT							GL-16
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				7/10/05	GL-15	Customers Control Account	575,000

And, the memorandum Sales Ledger is also updated:

SALES LEDGER						
JOHN SMITH						SL-30
Date	Ref	Description	Amount (Rs.) Debit		Credit	Balance (Rs.)
7/10/05	16	Khaddar exported for £ 5,000	575,000			575,000

When accounts are prepared for October '05, since payment is still pending, the balance of £ 5,000 will be re-translated. Since the exchange rate was Rs. 117 / £ on 31/10/05, the new Rupee balance works out to Rs. 585,000, i.e. a gain of Rs. 10,000. The following Accounting entries will be recorded:

GENERAL LEDGER							
EXCHANGE GAIN / LOSS ACCOUNT							GL-50
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				31/10/05	GL-15	Customers Control Account	10,000

GENERAL LEDGER							
CUSTOMERS CONTROL ACCOUNT							GL-15
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
31/10/05	GL-50	Exchange Gain / Loss Account	10,000				

And, the memorandum Sales Ledger will also get updated:

SALES LEDGER					
JOHN SMITH					SL-30
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance (Rs.) 575,000
31/10/05	JV 057/05	Exchange Gain	10,000		585,000

Subsequently, on 20/11/05, when payment is received from customer when the exchange rate was Rs. 118 / £:

GENERAL LEDGER							
BANK ACCOUNT							GL-20
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
20/11/05	GL-15	Customers Control Account	590,000				

GENERAL LEDGER							
CUSTOMERS CONTROL ACCOUNT							GL-15
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				20/11/05	GL-20	Bank Account	590,000

And, the memorandum Sales Ledger is also updated:

SALES LEDGER					
JOHN SMITH					SL-30
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance (Rs.) 585,000
20/11/05	BRV 040/05	Payment received		590,000	(5,000)

After payment was received, John Smith's Account in the Sales Ledger shows a credit balance of Rs. 5,000 i.e. that Hussain Khaddar owes the customer money! This obviously is not correct. If you look at the transactions, you will see that Rs. 5,000 represents

further exchange gain which has arisen because the exchange rate has moved from Rs. 117 to Rs. 118 / £ in between 31/10/05 and 20/11/05.

This gain will get recorded as follows:

GENERAL LEDGER							
EXCHANGE GAIN / LOSS ACCOUNT							GL-50
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				20/11/05	GL-15	Customers Control Account	5,000

GENERAL LEDGER							
CUSTOMERS CONTROL ACCOUNT							GL-15
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
20/11/05	GL-50	Exchange Gain / Loss Account	5,000				

And, the memorandum Sales Ledger will also get updated:

SALES LEDGER					
JOHN SMITH					SL-30
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance (Rs.) (5,000)
20/11/05	JV 057/05	Exchange Gain	5,000		Nil

You will have noted that, in this transaction, exchange gain / loss on this transaction was recorded two times – once at the time that accounts were prepared and then when payment was received in settlement.

102.3   AT A FORWARD RATE

To avoid risk and future uncertainty, Businesses can secure themselves against uncertain & unpredictable currency movements by entering into a forward rate with Banks. Through this forward rate mechanism, because the exchange rate is locked in, there is no question of exchange gain or loss as all transactions, whether of re-

translation or of payment received, will get translated at the forward rate.

The following example will show this:

EXAMPLE # 13.6

At a forward rate

Continuing from Example # 13.3, suppose Hussain Khaddar had entered into a forward rate with the Bank at £ 1 = Rs. 116. Other assumptions remain same.

On 7/10/05, because Hussain Khaddar has locked into a forward rate, the Accounting entries will be as follows:

GENERAL LEDGER							
CUSTOMERS CONTROL ACCOUNT							GL-15
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
7/10/05	GL-16	Sales Account	580,000				

GENERAL LEDGER							
SALES ACCOUNT							GL-16
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				7/10/05	GL-15	Customers Control Account	580,000

And, the memorandum Sales Ledger will also be updated:

SALES LEDGER					
JOHN SMITH					SL-30
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance (Rs.)
7/10/05	55	Khaddar exported for £ 5000	580,000		580,000

On 31/10/05, when accounts are prepared, no re-translation will be required because the forward rate contract is in place.

On 20/11/05, when payment is received:

GENERAL LEDGER							
BANK ACCOUNT							GL-20
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
20/11/05	GL-15	Customers Control Account	580,000				

GENERAL LEDGER							
CUSTOMERS CONTROL ACCOUNT							GL-15
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				20/11/05	GL-20	Bank Account	580,000

And, the memorandum Sales Ledger is also updated:

SALES LEDGER					
JOHN SMITH					SL-30
			Amount (Rs.)		Balance (Rs.)
Date	Ref	Description	Debit	Credit	580,000
20/11/05	BRV 056/05	Payment received		580,000	Nil

103 HOW DIFFERENT IS ACCOUNTING FOR IMPORT TRANSACTIONS?

Accounting for import transactions is very similar to Accounting for export transactions. However, when there is an increase in the exchange rate, it is an Exchange Gain for Exporters but is an Exchange Loss for Importers. Similarly, when exchange rates decrease, Exporters are worse off, i.e. incur an Exchange Loss, but Importers have lesser to pay, i.e. an Exchange Gain.

Therefore, in a nut shell, while the accounting of foreign currency transactions is similar for Exporters and Importers, the impact on either is the reverse of each other.

CHAPTER HIGHLIGHTS

What have we covered?

1. This chapter deals with accounting of the transaction with the foreign seller or buyer in the foreign currency.

2. The major risk associated with dealing in foreign currencies is that of adverse movement in exchange rates.

3. There are two mainly used exchange rates: spot and forward.

4. Buying rate means the rate at which the Bank will buy foreign currency and the Selling rate is at which the Bank will sell foreign currency.

5. Exchange gain or loss arises whenever there is an exchange rate movement between two dates.

6. Balances in foreign currencies should be translated into Rupees at the time that a transaction is originated.

7. If a foreign currency transaction is unsettled, the balances are re-translated.

8. Exchange gains or losses are accounted for through Journal Vouchers.