ACCOUNTING FOR THE FOREX TRANSACTIONS-A GLIMPSE

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The accounting procedures associated with FOREX transactions are helpful in various ways. For one, they let you understand the actual profit and loss on a FOREX transactions as long as you know how much cash you spent on it, or the transactions size and the exchange rate prices at the entry and exit of the transactions.

For understanding and accounting for the forex Transactions a due understanding of the regulations governing the accounting is required.eg.AS11 Effects of the Changes in the Foreign exchange Rates.

Foreign currency transactions are denominated in a currency other than the company's functional currency. Foreign currency transactions may result in receivables or payables fixed in the amount of foreign currency to be received or paid. A foreign currency transaction requires settlement in a currency other than the functional currency! A change in exchange rates between the functional currency and the currency in which a transaction is denominated increases or decreases the expected amount of functional currency cash flows upon settlement of the transaction. This change in expected functional currency cash flows is a "**foreign currency transaction gain or loss**" that typically is included in arriving at earnings in the income statement for the period in which the exchange rate is changed. **An example of a transaction gain or loss** is when an Italian subsidiary has a receivable denominated in lira from a British customer.

Similarly, a transaction gain or loss (measured from the transaction date or the most recent intervening balance sheet date, whichever is later) realized upon settlement of a foreign currency transaction usually should be included in determining net income for the period in which the transaction is settled.

Example:

An exchange gain or loss occurs when the exchange rate changes between the purchase date and sale date. Merchandise is bought for **100,000 pounds**. The "exchange rate" is 4 pounds to 1 dollar. **The journal entry is**:

[Debit]. Purchases = 25,000
[Credit]. Accounts payable = 25,000
(Note: 100,000/4 = $25,000)

When the merchandise is paid for, the exchange rate is 5 to 1. **The journal entry is**:

[Debit]. Accounts payable = 25,000
[Credit]. Cash = 20,000
[Credit]. Foreign exchange gain = 5,000
(Note: 100,000/5 = $20,000)

The $20,000 using an exchange rate of 5 to 1 can buy 100,000 pounds. **The transaction gain is the difference between the cash required** of $20,000 **and the initial liability** of $25,000.

Note that a foreign transaction gain or loss has to be determined at each balance sheet date on all recorded foreign transactions that have not been settled.

Another example:

A U.S. company sells goods to a customer in England on 11/15/X7 for 10,000 pounds. **The exchange rate is 1 pound is $0.75**. Thus, the transaction is worth $7,500 (10,000 pounds × 0.75). Payment is due two months later. **The entry on 11/15/X7 is**:

[Debit]. Accounts receivable—England = 7,500
[Credit]. Sales = 7,500

Accounts receivable and sales are measured in U.S. dollars at the transaction date employing the "spot rate". Even though the accounts receivable is measured and reported in U.S. dollars, the receivable is fixed in pounds. Thus, a "**transaction gain or loss**" can occur if the exchange rate changes between the transaction date (11/15/X7) and the settlement date (1/15/X8).

Since the financial statements are prepared between the transaction date and settlement date, receivables that are denominated in a currency other than the functional currency (U.S. dollar) have to be restated to reflect the spot rate on the balance sheet date. On December 31, 20X7, the exchange rate is 1 pound equals $0.80. Hence, the 10,000 pounds are now valued at $8,000 (10,000 × $.80). Therefore, the accounts receivable denominated in pounds should be upwardly adjusted by $500. **The required journal entry on 12/31/X7 is**:

[Debit]. Accounts receivable—England = 500
[Credit]. Foreign exchange gain = 500

The income statement for the year-ended 12/31/X7 shows an exchange gain of $500. **Note** that sales is not affected by the exchange gain since sales relates to operational activity.

On 1/15/X8, **the spot rate is 1 pound = $0.78**. The journal entry is:

[Debit]. Cash = 7,800
[Debit]. Foreign exchange loss = 200
[Credit]. Accounts receivable—England = 8,000

The 20X8 income statement shows an exchange loss of $200.

Note: **Which Transaction Gain Or Loss Should Not Be Reported In The Income Statement?**

Gains and losses on the following foreign currency transactions "**ARE NOT**" **included in earnings but rather are reported as translation adjustments**:

1. Foreign currency transactions designated as economic hedges of a net investment in a foreign entity, beginning as of the designation date.
2. Inter-company foreign currency transactions of a long-term investment nature (settlement is not planned or expected in the foreseeable future),when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting company's financial statements
3. A gain or loss on a forward contract or other foreign currency transaction that is intended to hedge an identifiable foreign currency commitment (e.g., an agreement to buy or sell machinery) should be deferred and included in the measurement of the related foreign currency transaction.

Losses should not be deferred if deferral is expected to result in recognizing losses in later periods. A foreign currency transaction is deemed a hedge of an identifiable foreign currency commitment if both of these conditions are met:

1. The foreign currency transaction is designated as a hedge of a foreign currency commitment.
2. The foreign currency commitment is firm.

Some Important Terms In Foreign Currency

1. Some key terms that you should be familiar with are:
2. **Conversion**: An exchange of one currency for another
3. **Currency Swap**: An exchange between two companies of the currencies of two different countries according to an agreement to re-exchange the two currencies at the same rate of exchange at a specified future date.

4. **Denominate**: Pay or receive in that same foreign currency. It can only be denominated in one currency (e.g., lira). It is a real account (asset or liability) fixed in terms of a foreign currency regardless of exchange rate.
5. **Exchange Rate**: The ratio between a unit of one currency and that of another at a specified date. If there is a temporary lack of exchangeability between two currencies at the transaction date or balance sheet date, the first rate available thereafter is used.
6. **Foreign Currency**: A currency other than the functional currency of the business (e.g., the dollar could be a foreign currency for a foreign entity).
7. **Foreign Currency Statements**: The financial statements using a functional currency as the unit of measure.
8. **Foreign Currency Transactions**: Transactions whose terms are denominated in a currency other than the entity's functional currency. Foreign currency transactions occur when a business (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, (c) is a party to an unperformed forward exchange contract, or (d) acquires or disposes of assets, or incurs or settles liabilities denominated in foreign currency.
9. **Foreign Currency Translation**: The expression in the reporting currency of the company those amounts that are denominated or measured in a different currency.
10. **Foreign Entity**: An operation (e.g., subsidiary, division, branch, joint venture) whose financial statements are prepared in a currency other than the reporting currency of the reporting entity.
11. **Functional Currency**: What is the functional currency? An entity's functional currency is the currency of the primary economic environment in which the business operates. It is usually the currency of the foreign country that the company primarily obtains and uses cash.
12. Before translation, the foreign country figures are re-measured in the "**functional currency**". **For example:** if a company in France is an independent entity and received cash and incurred expenses in France, the franc is the functional currency. However, if the French company was an extension of an Italian parent, the functional currency is the lira. The functional currency should be consistently used except if unusual material economic changes occur.
13. However, previously issued financial statements are not restated for a change in the functional currency. **If a company's books are not kept in its functional currency, re-measurement into the functional currency is required**. The re-measurement process occurs before translation into the reporting currency. When a foreign entity's functional currency is the reporting currency, re-measurement into the reporting currency obviates translation. The re-measurement process generates the same result as if the company's books had been kept in the functional currency.

Determination of The Functional Currency

There are guidelines to determine the functional currency of a foreign operation. **The ''benchmarks'' apply to selling price, market, cash flow, financing, expense, and inter-company transactions**. A detailed discussion follows:

Selling price – The functional currency is the foreign currency when the foreign operation's selling price of products or services arises primarily from local factors such as government law. It is not caused by changes in exchange rate. The functional currency is the parent's currency when foreign operation's sales prices apply in the short run to fluctuation in the exchange rate emanating from international factors (e.g., worldwide competition).

Market – The functional currency is the foreign currency when the foreign activity has a strong local sales market for products or services even though a significant amount of exports may exist. The functional currency is the parent's currency when the foreign operation's sales market is mostly in the parent's country.

Cash flow – The functional currency is the foreign currency when the foreign operation's cash flows are predominately in foreign currency not directly impacting the parent's cash flow. The functional currency is the parent's currency when the foreign operation's cash flows affect the parent's cash flows. They are typically available for remittance via inter-company accounting settlement.

Financing – The functional currency is the foreign currency if financing the foreign activity is in foreign currency and funds obtained by the foreign activity are adequate to satisfy debt payments. The functional currency is the parent's currency when financing foreign activity is provided by the parent or occurs in U.S. dollars. The funds obtained by the foreign activity are inadequate to meet debt requirements.

Expenses – The functional currency is the foreign currency when a foreign operation's production costs or services are usually incurred locally. However, there may be some foreign imports. The functional currency is the parent's currency when a foreign operation's production and service costs are mostly component costs obtained from the parent's country.

Inter-company transactions – The functional currency is the foreign currency when minor interrelationships exist between the activities of the foreign entity and parent except for competitive advantages (e.g., patents). There are a few inter-company transactions. The functional currency is the parent's currency when significant interrelationships exist between the foreign entity and parent. There are many inter-company transactions.

Consistent use should be made of the functional currency of the foreign entity over the years unless a significant change in circumstances takes place. **If a change in the functional currency occurs, it is treated as a change in estimate**.

Local currency – The currency of the foreign country.

Measure – A translation into a currency other than the original reporting currency. The foreign financial statements are measured in U.S. dollars by using the appropriate exchange rate.

Reporting currency – The currency in which the business prepares its financial statements is typically U.S. dollars.

Spot rate – The exchange rate for immediate delivery of currencies exchanged.

Transaction gain or loss – Transaction gains or losses arise from a change in exchange rates between the functional currency and the currency in which a foreign currency transaction is denominated. They represent an increase or decrease in (a) the actual functional currency cash flows realized upon settlement of foreign currency transactions and (b) the expected functional currency cash flows on unsettled foreign currency transactions.

Translation adjustments – Translation adjustments arise from translating financial statements from the entity's functional currency into the reporting one.

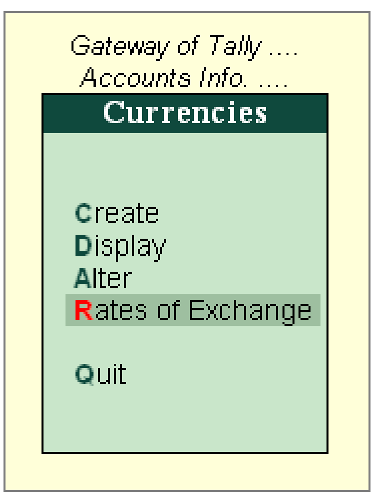
ACCOUTING FEATURES AVAILABLE IN TALLY 9

Defining Rates of Exchange

In the **Rates of Exchang**e menu, you can specify the rate of foreign currency for a specific date. Foreign exchange variations occur every day with different selling and buying rates. Rates of Exchange feature helps you record rate of Currency for particular date and apply in your transactions.

To **Display/Alter** Rates of Exchange:

Go to **Gateway of Tally > Accounts Info > Currencies > Rates of Exchange**



Enter to view the **Multi Currency** Alteration screen as shown :

Multi Currency Alteration — ABC Company — Ctrl + M

Date for Rate of Exchange : 1-Apr-2008

S.No.	Currency	Std. Rate	Selling Rate: Last Voucher Rate	Selling Rate: Specified Rate	Buying Rate: Last Voucher Rate	Buying Rate: Specified Rate
1.	$ (Dollar)			Rs. 600/$		Rs. 500/$
2.	A$ (Australian Dollar)	Rs. 100/A$		Rs. 250/A$		Rs. 200/A$
3.	¥ (Yen)	Rs. 160/¥		Rs. 400/¥		Rs. 250/¥

1. Enter the **date** for which the exchange rate is applicable
2. Enter the **Standard Rate (optional)** which is used to calculate variances from the actual transaction rates
3. Enter the **Selling Rate** (your selling rate)
4. Enter the **Buying Rate** (your buying rate)
5. Accept to **Save**

Note: Last Voucher Rate is displayed, if any voucher has been entered earlier.

Selling Rate � Specified Rate

Selling rate is your selling rate (as opposed to bank's selling rate) used for receipt voucher entry where you receive foreign exchange.

This is the rate obtained from your banker or also available in the daily newspaper. Once the Selling Rate is specified in the Rates of Exchange menu, while entering a foreign exchange transaction, the rates are defaulted automatically. However, you can alter the rate as required.

The **actual rate** at which the currency was last used is displayed and cannot be changed.

The **specified rate** is used for calculating foreign exchange variances only in case where there is no standard rate.

Buying Rate � Specified Rate

Buying Rate is your buying rate (as opposed to bank's buying rate) used in payment vouchers.

The **actual rate** at which the currency was last used is displayed and cannot be changed.

The **specified rate** is used for calculating foreign exchange variances only in case where there is no **standard rate**.

Note: Tally.ERP 9 automatically calculates Forex Gain or Loss for **foreign exchange transactions** using the standard rates, specified rates and actual transaction rates specified in the **Rates of Exchange** menu.

Buttons available in the Rates of Exchange screen:

Buttons	Keys	Description and usage
G :Groups	Ctrl+G	User is allowed to create **Accounting Group** from the **Rates of Exchange** screen.
L: Ledgers	Ctrl+L	User is allowed to create **Accounting Ledgers** from the **Rates of Exchange** screen.
S: Cst Cat	Ctrl+S	User is allowed to create **Cost Category** from the **Rates of Exchange** screen.
C: Cst Ctr	Ctrl+C	User is allowed to create **Cost Centre** from the **Rates of Exchange** screen.

Tally's multi-currency feature is very powerful and able to easily handle all facets of multi-currency transactions.

Your books are maintained in Base Currency - the currency specified for the company on its creation. This is necessary so that all amounts show an identical currency - to easily analyse them. Hence, even when you transact in a currency other that the Base, the information that will be displayed by Tally in the first instance will be converted figures to the Base currency. You cannot possibly add Rupees with Pounds, can you? Just like you cannot add pieces with kilograms. You must convert one to the other using a rate of exchange.

Activate the feature 'Allow Multi-Currency' in F11:Company Features.

1. Return to the Gateway of Tally.
2. Select Accounts Info, Currencies, Create.
3. For each prompt give the information as follows:
4. Symbol: $.
5. Formal name: US Dollars.
6. Number of Decimal Places: 2
7. Show Amounts in Millions: No.
8. Is symbol suffixed to Amounts: No
9. Put Space: Yes

Similarly, create £ with formal name Pounds Sterling.

Alter currencies

1. Reverse into the Currencies menu.
2. Select Alter.
3. Select $.
4. The alteration screen is different! It contains much more information.
5. You can, of course, change information here but you can also input dates and the relevant exchange rate of the currency.
6. Note three columns for the Rate of Exchange - Standard, Selling and Buying.
7. Bring your cursor to the Date field in the Standard column.
8. Enter the following rates for 1-12-98. Enter the date in the date field.

Standard	Selling	Buying
Rs.35/$	Rs.36/$	Rs.37/$

9. Accept the screen.
10. Standard is the standard or the current rate of exchange. Specified Selling rate is the rate at which your bank will buy Dollars from you. Buying rate is the rate at which you will buy dollars from the Bank. You use Selling rate when invoicing or receiving money and Buying rate Purchasing or paying money in foreign currency.
11. If the rates are filled here, then during voucher entry they are picked up automatically. We will see it in a moment.

Delete currencies

Use the key combination [ALT]+[D] in the alteration screen to delete. As usual, you cannot delete a currency if it has been used.

Create Foreign Currency Bank Account

1. Return to Accounts Info under Gateway of Tally.
2. Select Ledgers, Create.
3. Name : Dollar Account.
4. Under: Bank Accounts.
5. Currency: $
6. Accept the rest of the screen.
7. Create two ledger accounts, Foreign Customer (Sundry Debtors) and Foreign Supplier (Sundry Creditors).
8. Currency of the account will be the base currency. All accounts should be in base currency except the Bank as above. Bill-wise - Yes.

Tally Walk-through for Voucher Entry using foreign currency

Foreign currency in stock items and bill-wise details

1. Select Voucher Entry from the Gateway of Tally.
2. Select Sales

3. Your objective is to raise a sales invoice in $.
4. Date 15/12/98
5. Select As invoice.
6. Party's name - Foreign Customer
7. Accept the name, address as defaults
8. Item name - Wheat (if it is not present, create it using [alt]+[C], Stock Group Foodstuffs, Stock Category - Cereals, Unit - Bags)
9. Tracking numbers and order number if they appear - Not Applicable
10. Godown - Warehouse
11. Qty - 100 Bags
12. Rate - $25 per Bag. Do not forget the $ symbol.
13. Rate of Exchange - accept the default selling rate which is Rs.36/$
14. Accept the rest of the inventory allocation screen.
15. Accounting Allocation - Export Sales (If it is not present, create it using [alt]+[C]. Inventory values - Yes)
16. Cost Centre Allocation - Amar
17. There are no other entries for this voucher except Billwise allocation.
18. Billwise - New Ref Export/17 days $2500. This must be in the foreign currency.
19. Accept the screen.

Display foreign exchange gain/loss

Let's see the impact of the above entry.

1. Return to Gateway of Tally.
2. Display Balance Sheet.
3. Do you see a line 'Unadjusted Forex Gain/Loss' for the amount of 2500.00?
4. Press Enter and drill down to the 'Gain/Loss due to Exchange Variation' Screen.
5. This screen gives you the billwise information of the reference Export/1. The Pending amount is US$2500. But why is there a Gain/Loss?

The Gain/Loss is calculated because the transacted rate is Rs.36/$ whereas the current standard rate is Rs.35/$. The difference between the transaction rate and the current standard rate is Re.1/$ amount to Rs.2500.00.

Adjusting a forex bill

1. Foreign Customer pays you $2000 and then you deposit the sum in your Dollar Account. Bank charges $50.
2. Go to Voucher Entry.
3. Select Receipt
4. Date: 20/12/98
5. Cr Foreign Customer $2000.
6. Rate of exchange has moved since then. It is now Rs.39/$
7. BillWise - Agst Ref. Export/1 $2000.
8. Dr Dollar Account $ 1950 Rate of Exchange Rs.39/$
9. Dr Bank Charges $50. Same rate of exchange.
10. Now display foreign exchange gain/loss again as you had done before.

What do you find?

The Unadjusted Gain/Loss is 2300. Drill down. You now have gain loss for Sundry Debtors as well as for Bank Accounts.

Let us examine the Sundry Debtors situation.

The amount of Gain/Loss has increased from Rs. 2500 to Rs. 5500. Why?

Invoice amount	$2500 @ Rs.36/$
Received	$2000 @ Rs.39/$
Gain on receipt amount	$2000 @ Rs.3/$ = Rs. 6000

However, the balance $500 will have a loss of Rs. 1/$ the difference between the standard rate and the invoice transaction rate.

Hence, the net gain of Rs. 5,500. Wonderful, isn't it?

Bank Balance **Forex** Gain/Loss

Now lets see the Bank Accounts Forex Gain/Loss.

1. Go to the Balance Sheet.
2. Simply drill down from the Unadjusted Forex Gain/Loss, Current Assets, Bank Accounts, Dollar Account.
3. The difference is because the worth of the Dollars in the Account in terms of Rupees has reduced. That is to say, it was received @ Rs. 39/$ but now the current standard rate is Rs. 35/$. Hence, the account $1950 @ Rs. 4/$ = Rs. 7800.

Adjust forex gain or loss

The forex gain or loss incurred on the transactions and the balances are left unadjusted by Tally as the amounts change with daily change in standard rates of exchange. At the end of the accounting period. You must journalise this unadjusted gain/loss so that it is written to the Profit & Loss Account.

Tally Walk through to adjust forex gain or loss

First you must know what the exchange gain/loss is. Therefore,

- Display Balance Sheet
- Drill down into the Unadjusted Forex Gain/Loss.
- You will eventually come to the Forex Gain/Loss Statement showing

Current Assets	**Dr**	**Cr**
Sundry Debtors		5500
Bank Accounts	7800	

This shows a gain of Rs. 5500 and a loss of Rs. 7800

- Click on Detailed to explode the Groups. If Sundry Debtors does not explode, use [Shift]+[Enter] on it. Hence, Sundry Debtors will show Foreign Customer with the Amount. Bank Accounts will show Dollar Account.

- Print this statement or copy it by hand.
- Now create a ledger account by the name 'Forex Gain/Loss (it could be any name) under the group indirect Expenses.
- Return to Gateway of Tally.
- Select to Accounts info -> Voucher Types.
- Select to Alter Journal.
- Tab down to the line Name of Class.
- Type Forex gain/Loss and press Enter.
- Use Class for Forex Gain/Loss Adjustments? Type Y or Yes.
- Under the Ledger Name select 'Forex Gain/Loss'. This is the Account that will be used for adjustment.
- Press Enter to accept. You will return to the Voucher Type Alteration screen below the class you have just created. Press Enter repeatedly to accept.
- Return to Gateway of Tally.
- Select Voucher Entry.
- Press F7:Journal. You now get Voucher Type Selection box where you select Journal and Class Table **Forex Gain/Loss**.
- Change date to 31-12-98.
- Now
    - Select Foreign Customer from the list of ledgers. The Bill-wise details sub-screen comes up. Select the invoice Export/1 which is the only one in the list. In fact, only those invoices involved in foreign exchange gain/loss will be available for selection. The amount displayed will be the gain/loss amount. Hence simply select it. Accept the amount and then End of List to complete selection for Foreign Customer.
    - Now you are in the second line and in Particulars column of the voucher. Select Foreign Supplier. Repeat the process of selection of the invoice.
    - In the Third line and in Particulars column do not adjust Dollar Account. Press Enter at the blank field to go to the Narration.
    - Type 'Party accounts adjusted for exchange gain and loss'.