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Bachelor of Commerce (B2001) | Level 3 • Part B Major | Monash University

# Advanced financial accounting

Course Code: ACC3100 • Module 2 Notes

# Module 2: Foreign Currency Transactions, Hedging & Translation of Foreign Operations

## 2.1 Currency Concepts & Functional vs Presentation Currency (*AASB 121*)

Australian entities operate in an open, trade-exposed economy. ASX-listed resource giants such as BHP and Rio Tinto price iron ore and copper in United States dollars (USD), Australian retailers import inventory denominated in USD, euros (EUR), or renminbi (CNY), and domestic corporate groups own subsidiaries across New Zealand, Singapore, the United Kingdom, and North America. *AASB 121 The Effects of Changes in Foreign Exchange Rates* prescribes how an entity translates foreign currency transactions into its measurement currency and translates foreign operations into a group presentation currency.

*AASB 121* distinguishes three distinct currency concepts:

- **Functional currency:** The currency of the *primary economic environment* in which the entity operates. This is an entity-specific, economic-substance determination—not a free choice. Every entity (including each subsidiary, associate, or branch) must identify its functional currency.
- **Foreign currency:** Any currency other than the functional currency of the entity. For example, if an Australian mining subsidiary operates in the Pilbara with USD as its functional currency, transactions denominated in Australian dollars (AUD)—including local payroll and corporate income tax—are *foreign currency transactions* for that subsidiary!
- **Presentation currency:** The currency in which the financial statements are presented. Unlike the functional currency, an entity is free to choose its presentation currency (for Australian statutory lodgements with ASIC under the *Corporations Act 2001 (Cth)*, this is ordinarily AUD, though ASX-listed entities with predominantly USD operations frequently present in USD).

### Determining the Functional Currency (*AASB 121.9–14*)

An entity determines its functional currency by evaluating primary indicators first, followed by secondary and foreign-operation indicators if primary factors are mixed:

| Indicator Tier | Criteria Under *AASB 121* | Australian Practical Illustration |
|---|---|---|
| **Primary Indicators (*AASB 121.9*)** | (a) Currency that mainly influences **sales prices** for goods and services (often the currency in which prices are denominated and settled) and of the country whose competitive forces and regulations mainly determine sales prices.<br>(b) Currency that mainly influences **labour, material, and other costs** of providing goods or services. | An Australian LNG exporter whose global sales contracts, spot pricing, and major capital equipment leases are denominated in USD—even though domestic wages are paid in AUD—often concludes its functional currency is USD. |

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| Indicator Tier | Criteria Under *AASB 121* | Australian Practical Illustration |
|---|---|---|
| **Secondary Indicators (*AASB 121.10*)** | (a) Currency in which funds from **financing activities** (debt and equity instruments) are generated.<br>(b) Currency in which receipts from **operating activities** are usually retained. | An Australian fintech issuing AUD equity on the ASX and retaining AUD cash balances at NAB/CBA reinforces AUD as its functional currency when primary indicators are mixed. |
| **Foreign Operation Indicators (*AASB 121.11*)** | (a) Whether the foreign operation acts as an *extension* of the parent (little autonomy) vs operates with *significant autonomy*.<br>(b) Proportion of transactions with the parent.<br>(c) Whether cash flows directly affect parent cash flows and are readily remittable.<br>(d) Whether foreign operation cash flows suffice to service existing/normal debt obligations without parent funds. | A sales distribution subsidiary in Auckland that buys inventory from its Melbourne parent, remits proceeds weekly, and has pricing set by Melbourne is an extension of the parent (functional currency: AUD). An autonomous New Zealand manufacturing subsidiary sourcing local inputs, borrowing in NZD, and selling locally has NZD as its functional currency. |

Once determined, the functional currency is not changed unless there is a genuine change in the underlying transactions, events, and conditions. Any change in functional currency is accounted for **prospectively** from the date of the change (translating all items into the new functional currency using the exchange rate at that date, which then becomes historical cost for non-monetary items).

### Monetary vs Non-Monetary Items (*AASB 121.16*)

Correctly translating foreign currency balances at reporting date requires separating monetary from non-monetary items. The essential feature of a **monetary item** is a right to receive (or an obligation to deliver) a *fixed or determinable number of units of currency*. Examples include cash and bank deposits, trade receivables and payables, loans, lease liabilities under *AASB 16*, dividends payable, provisions settled in cash under *AASB 137*, and deferred tax assets/liabilities. Conversely, the essential feature of a **non-monetary item** is the *absence* of a right to receive or obligation to deliver a fixed or determinable number of units of currency: examples include inventory, property, plant and equipment, right-of-use assets, goodwill, intangible assets, prepaid expenses, and contract liabilities (unearned revenue) for goods/services to be delivered.

## 2.2 Accounting for Foreign Currency Transactions (*AASB 121.20–34*)

When an entity enters into a transaction denominated in a foreign currency (such as importing machinery invoiced in USD or borrowing in EUR), *AASB 121* mandates a clear sequence of initial recognition, reporting-date remeasurement, and settlement.

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## Exchange Rate Quotations in Australia

In Australian foreign exchange markets, exchange rates are predominantly quoted in **indirect (reciprocal) terms** relative to the Australian dollar: for example, $\text{AUD } 1.00 = \text{USD } 0.6600$ (meaning one Australian dollar buys 0.66 US dollars). Under indirect quotation, converting a foreign currency amount ($FC$) into Australian dollars ($AUD$) requires *dividing* by the indirect exchange rate ( $R_{\text{indirect}}$). Conversely, under **direct quotation** (foreign currency units priced in AUD, e.g., $\text{USD } 1.00 = \text{AUD } 1.5152$), converting $FC$ into $AUD$ requires *multiplying* by the direct rate ($R_{\text{direct}}$ ):

$$V_{\text{AUD}} = \frac{V_{\text{FC}}}{R_{\text{indirect}}} = V_{\text{FC}} \times R_{\text{direct}}$$

Where:

- $V_{\text{AUD}}$ = Translated value in Australian dollars (functional currency).
- $V_{\text{FC}}$ = Amount denominated in the foreign currency (e.g., USD, EUR, NZD).
- $R_{\text{indirect}}$ = Indirect exchange rate expressed as units of foreign currency per A$1.00 (e.g., $0.6600\ \text{USD/AUD}$).
- $R_{\text{direct}} = 1/R_{\text{indirect}}$ = Direct exchange rate expressed as AUD per 1 unit of foreign currency.

A rise in the indirect quote (e.g., AUD/USD moving from 0.6500 to 0.7000) means the Australian dollar has **appreciated**: fewer AUD are required to settle a USD liability (generating an FX gain on USD payables and an FX loss on USD receivables). A fall in the indirect quote (e.g., from 0.6500 to 0.6200) means the Australian dollar has **depreciated**: more AUD are required to settle a USD liability (generating an FX loss on USD payables and an FX gain on USD receivables).

## Initial Recognition and Subsequent Measurement Rules

1. **Initial Recognition (Transaction Date):** A foreign currency transaction is recorded on initial recognition in the functional currency by applying the **spot exchange rate** at the date of the transaction (where the transaction first qualifies for recognition under Australian Accounting Standards—for example, when control of goods transfers under *AASB 15* or *AASB 102*).
2. **End of Each Reporting Period:**
   - **Monetary items** are retranslated using the **closing rate** (the spot rate at reporting date). All resulting exchange differences are recognised immediately in **profit or loss** (except exchange differences on a monetary item forming part of a net investment in a foreign operation in consolidated financial statements, which go to OCI/FCTR).
   - **Non-monetary items measured at historical cost** remain translated at the **historical spot rate** at the transaction date (they are *never* retranslated for FX movements; however, when testing inventory for lower of cost and NRV under *AASB 102* or PPE for impairment under *AASB 136*, the recoverable amount/NRV in foreign currency is translated at the closing rate and compared to the historical AUD carrying amount).
   - **Non-monetary items measured at fair value** (such as revalued land under *AASB 116* or FVOCI equity investments under *AASB 9*) are translated using the exchange rate at the date fair

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value was measured. Under *AASB 121.30*, the FX component of the fair value change follows the underlying gain or loss: if the valuation gain/loss goes to OCI (e.g., land revaluation), the FX component goes to OCI; if to profit or loss (e.g., investment property under *AASB 140*), the FX component goes to profit or loss.

3. **Settlement Date:** When a monetary asset or liability is settled in a subsequent period, the cash paid or received is translated at the settlement-date spot rate, and the difference between that AUD amount and the carrying amount from the previous reporting date (or initial recognition if within the same period) is recognised in profit or loss as an FX gain or loss.

## Worked Numerical Example 1: Foreign Currency Equipment Purchase & Settlement Across Balance Date

**Scenario:** On 15 May 2026, **Pacific Medical Supplies Pty Ltd** (an Australian company with AUD functional currency and 30 June year-end) purchases specialised imaging equipment from a US manufacturer on credit for US$500,000, payable in 90 days on 13 August 2026. The equipment is delivered and control passes on 15 May 2026 (depreciation begins 1 July 2026). Relevant spot exchange rates (indirect quotes: foreign currency per A$1.00) are:

- 15 May 2026 (transaction date): $\text{AUD } 1.00 = \text{USD } 0.6500$
- 30 June 2026 (reporting date): $\text{AUD } 1.00 = \text{USD } 0.6250$
- 13 August 2026 (settlement date): $\text{AUD } 1.00 = \text{USD } 0.6400$

**Step 1: Initial Recognition on 15 May 2026**

Equipment cost in AUD = $\text{USD } 500,000 / 0.6500 = \text{AUD } 769,231$ (rounded to nearest dollar). Equipment is a non-monetary asset at historical cost; Accounts Payable is a monetary liability.

**Step 2: Reporting Date Remeasurement on 30 June 2026**

Equipment remains at historical cost of A$769,231 (not retranslated). Accounts Payable is retranslated at the closing rate of 0.6250: $\text{USD } 500,000 / 0.6250 = \text{AUD } 800,000$. Because AUD depreciated from 0.6500 to 0.6250, the liability increased by $\text{AUD } 800,000 - \text{AUD } 769,231 = \text{AUD } 30,769$, resulting in an unrealised FX loss in FY2026 profit or loss.

**Step 3: Settlement on 13 August 2026**

Cash required to buy US$500,000 at settlement spot rate 0.6400 = $\text{USD } 500,000 / 0.6400 = \text{AUD } 781,250$. Comparing against the 30 June 2026 carrying amount of A$800,000, AUD appreciated partially, creating a realised FX gain in FY2027 of $\text{AUD } 800,000 - \text{AUD } 781,250 = \text{AUD } 18,750$. (Net cumulative FX loss across both periods = $\text{AUD } 30,769 - \text{AUD } 18,750 = \text{AUD } 12,019$, matching $\text{AUD } 781,250 - \text{AUD } 769,231$.)

| Date | Journal Entry (Pacific Medical Supplies Pty Ltd) | Dr (A$) | Cr (A$) |
|---|---|---|---|
| 15 May 2026 | Dr Medical Equipment (PPE)<br>Cr Accounts Payable (USD) | 769,231 | 769,231 |
| 30 Jun 2026 | Dr Foreign Exchange Loss (P&L)<br>Cr Accounts Payable (USD) | 30,769 | 30,769 |

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| Date | Journal Entry (Pacific Medical Supplies Pty Ltd) | Dr (A$) | Cr (A$) |
|---|---|---|---|
| 13 Aug 2026 | Dr Accounts Payable (USD)<br>Cr Foreign Exchange Gain (P&L)<br>Cr Cash at Bank | 800,000 | 18,750<br>781,250 |

## 2.3 Translation of Foreign Operations & Foreign Currency Translation Reserve (FCTR)

When an Australian parent group consolidates a foreign subsidiary—or equity accounts a foreign associate—whose functional currency differs from the group's presentation currency (AUD), the foreign operation's financial statements must be translated from its functional currency into AUD before consolidation or equity accounting. *AASB 121.39* prescribes the **Closing Rate (Current Rate) Method** for entities whose functional currency is not that of a hyperinflationary economy.




Two-Stage Translation Framework under AASB 121

### Translation Rules Under the Closing Rate Method

| Financial Statement Element | Required Translation Rate (*AASB 121.39–47*) | Treatment of Exchange Difference |
|---|---|---|
| **All Assets & Liabilities** (both monetary and non-monetary, including comparatives) | **Closing rate** at the reporting date of each Statement of Financial Position. | Recognised in Other Comprehensive Income (OCI) and accumulated in the **Foreign Currency Translation Reserve (FCTR)**. |
| **Income & Expenses** (including depreciation and tax) | **Spot exchange rates** at the dates of transactions (or an **average rate** for the period as a practical approximation unless exchange rates fluctuated significantly). | Difference between average/spot translation of profit and closing-rate translation of resulting net assets flows into **FCTR (OCI)**. |
| **Equity Items** (Share Capital, Pre-acquisition Reserves, Dividends) | **Historical spot rates** (acquisition date for pre-acquisition equity; transaction date for post-acquisition share issues or dividends declared/paid). | Post-acquisition Retained Earnings is carried forward as cumulative translated profits less translated dividends (not retranslated at closing rate). |

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| Financial Statement Element | Required Translation Rate (*AASB 121.39–47*) | Treatment of Exchange Difference |
|---|---|---|
| **Goodwill & Fair Value Adjustments (FVA)** on acquisition | Treated as assets/liabilities of the foreign operation (*AASB 121.47*) and translated at the **closing rate** at each reporting date. | Annual retranslation difference on goodwill and unamortised FVA is recognised in **FCTR (OCI)** (shared with NCI if full goodwill or FVA applies). |

## Mathematical Proof & Verification of the FCTR Movement

A hallmark of rigorous consolidation under *AASB 121* is reconciling the FCTR movement independently rather than treating it solely as a trial-balance plug. For a foreign subsidiary whose opening net assets equal $NA_0$ (in functional currency), earning profit $NP$ translated at average rate $R_{\text{avg}}$ and paying dividends $Div$ at declaration/payment rate $R_{\text{div}}$, closing net assets in functional currency equal $NA_1 = NA_0 + NP - Div$. The period's FCTR movement ($\Delta FCTR_{\text{NA}}$) on the subsidiary's recorded net assets satisfies:

$$\Delta FCTR_{\text{NA}} = NA_0\left(\frac{1}{R_1} - \frac{1}{R_0}\right) + NP\left(\frac{1}{R_1} - \frac{1}{R_{\text{avg}}}\right) - Div\left(\frac{1}{R_1} - \frac{1}{R_{\text{div}}}\right)$$

Where:

- $\Delta FCTR_{\text{NA}}$ = Foreign currency translation reserve movement for the period on recorded net assets (in AUD, under indirect FX quotes where $R$ is foreign currency per A$1.00).
- $NA_0$ = Opening net assets (or acquisition-date net assets in year 1) in functional currency.
- $NP$ = Profit after tax for the period in functional currency.
- $Div$ = Dividends declared/paid during the period in functional currency.
- $R_0, R_1, R_{\text{avg}}, R_{\text{div}}$ = Indirect exchange rates (FC per A$1.00) at opening/acquisition, closing, period average, and dividend date respectively.

Additionally, any consolidation goodwill ($GW_{\text{FC}}$) and net after-tax FVA ($FVA_{\text{FC}}$) measured in the foreign operation's functional currency generate their own FCTR retranslation component equal to $GW_{\text{FC}}(1/R_1 - 1/R_0)$. Where a subsidiary is partly owned, the FCTR movement (on net assets, and on FVA and full goodwill if applicable) is allocated between the parent's FCTR in equity and NCI based on ownership proportions.

Upon partial or complete **disposal of a foreign operation** (loss of control, joint control, or significant influence), *AASB 121.48* requires that the cumulative amount of FCTR attributable to that foreign operation be **reclassified (recycled) from equity to profit or loss** as part of the gain or loss on disposal. (If the parent merely sells shares without losing control, the proportional share of FCTR is reattributed from parent equity to NCI rather than recycled to P&L.)

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## Worked Numerical Example 2: Full Foreign Subsidiary Translation & FCTR Proof

**Scenario:** On 1 July 2025, **Tasman Retail Ltd** (Australian parent, AUD functional and presentation currency) acquired 100% of **Kiwi Outdoors Ltd** (New Zealand subsidiary, NZD functional currency) for NZ$2,200,000 when Kiwi Outdoors' net assets comprised Share Capital of NZ$1,500,000 and Retained Earnings of NZ$500,000 (all identifiable assets and liabilities were at fair value; goodwill = NZ$200,000). During FY2026, Kiwi Outdoors earned net profit of NZ$400,000 and paid a dividend of NZ$100,000 on 31 March 2026. Relevant exchange rates (NZD per A$1.00) are:

- 1 July 2025 ($R_0$): $\text{AUD } 1.00 = \text{NZD } 1.1000$
- FY2026 Average ($R_{\text{avg}}$): $\text{AUD } 1.00 = \text{NZD } 1.0800$
- 31 March 2026 Dividend ($R_{\text{div}}$): $\text{AUD } 1.00 = \text{NZD } 1.0600$
- 30 June 2026 Closing ($R_1$): $\text{AUD } 1.00 = \text{NZD } 1.0500$

**Step 1: Translate Kiwi Outdoors' Financial Statements at 30 June 2026**

- Opening Net Assets (1 July 2025) = NZ$2,000,000 translated at 1.1000 = A$1,818,182 (Share Capital A$1,363,636 + Pre-acq Retained Earnings A$454,545).
- FY2026 Profit = NZ$400,000 translated at 1.0800 = A$370,370.
- FY2026 Dividend = NZ$100,000 translated at 1.0600 = A$94,340.
- Closing Retained Earnings (pre-FCTR) = $\text{AUD } 454,545 + \text{AUD } 370,370 - \text{AUD } 94,340 = \text{AUD } 730,575$.
- Closing Net Assets in NZD = $\text{NZD } 2,000,000 + \text{NZD } 400,000 - \text{NZD } 100,000 = \text{NZD } 2,300,000$.
- Closing Net Assets translated at closing rate 1.0500 = $\text{NZD } 2,300,000 / 1.0500 = \text{AUD } 2,190,476$.
- Translated Share Capital + Closing Retained Earnings = $\text{AUD } 1,363,636 + \text{AUD } 730,575 = \text{AUD } 2,094,211$.
- FCTR on Subsidiary Net Assets = $\text{AUD } 2,190,476 - \text{AUD } 2,094,211 = \text{AUD } 96,265$ (credit balance in equity).

**Step 2: Independent Formula Verification of FCTR on Net Assets**

- On Opening Net Assets: $\text{NZD } 2,000,000 \times (1/1.0500 - 1/1.1000) = 1,904,762 - 1,818,182 = +\text{AUD } 86,580$.
- On FY2026 Profit: $\text{NZD } 400,000 \times (1/1.0500 - 1/1.0800) = 380,952 - 370,370 = +\text{AUD } 10,582$.
- On Dividend Paid: $-\text{NZD } 100,000 \times (1/1.0500 - 1/1.0600) = -(95,238 - 94,340) = -\text{AUD } 898$.
- Sum = $\text{AUD } 86,580 + \text{AUD } 10,582 - \text{AUD } 898 = \text{AUD } 96,264$ (A$1 rounding), reconciling exactly!

**Step 3: Goodwill Translation**

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Goodwill at acquisition (1 July 2025) = $\text{NZD } 200,000 / 1.1000 = \text{AUD } 181,818$. At 30 June 2026, goodwill is retranslated at the closing rate 1.0500: $\text{NZD } 200,000 / 1.0500 = \text{AUD } 190,476$. The increase of $\text{AUD } 190,476 - \text{AUD } 181,818 = \text{AUD } 8,658$ is credited to FCTR (OCI). Total consolidated FCTR at 30 June 2026 = $\text{AUD } 96,265 + \text{AUD } 8,658 = \text{AUD } 104,923$.

## 2.4 Derivatives & Hedge Accounting Foundations (*AASB 9* Chapter 6)

Treasury departments in Australian corporations actively manage foreign exchange, interest rate, and commodity price volatility using derivatives such as forward exchange contracts (FECs), foreign currency options, and cross-currency interest rate swaps. Under *AASB 9 Financial Instruments*, all derivatives are recognised on the balance sheet at fair value and measured at **fair value through profit or loss (FVTPL)** by default. However, if the underlying commercial exposure is a future forecast sale or purchase (not yet recognised on the balance sheet) or an item measured at amortised cost, recognising derivative fair value swings immediately in P&L creates artificial earnings volatility—an **accounting mismatch**. Hedge accounting under Chapter 6 of *AASB 9* resolves this mismatch by aligning the timing of gain/loss recognition between the hedging instrument and the hedged item.

### Qualifying Criteria for Hedge Accounting (*AASB 9.6.4.1*)

Hedge accounting is optional, not mandatory. To apply it, an entity must satisfy three strict criteria at inception and throughout the hedge:

1. **Eligible Hedging Instruments and Hedged Items:** Hedging instruments are normally derivatives measured at FVTPL (such as forward FX contracts or swaps, though non-derivative financial assets/liabilities at FVTPL may hedge non-equity risks, and non-derivative FX loans may hedge FX risk). Written options generally do not qualify unless offsetting a purchased option. Eligible hedged items include recognised assets/liabilities, unrecognised firm commitments, highly probable forecast transactions, or net investments in foreign operations.
2. **Formal Designation and Documentation:** At inception of the hedge, management must formally document the risk management objective and strategy, identify the hedging instrument, the hedged item, the nature of the risk being hedged, and the methodology for assessing hedge effectiveness. Retrospective "back-dated" designation is strictly prohibited.
3. **Hedge Effectiveness Requirements:**
    - There is an *economic relationship* between the hedged item and the hedging instrument (values generally move in opposite directions in response to the hedged risk).
    - The effect of *credit risk* does not dominate the value changes resulting from that economic relationship.
    - The *hedge ratio* (quantity of hedging instrument relative to quantity of hedged item) is the same as that used for actual risk management—preventing deliberate under- or over-hedging designed to manipulate accounting outcomes.

Importantly, *AASB 9* removed the rigid 80%–125% bright-line quantitative effectiveness threshold that existed under legacy *AASB 139*, replacing it with qualitative/quantitative prospective assessment and mandatory recognition of any actual hedge ineffectiveness in profit or loss.

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### Fair Value of a Forward Exchange Contract

At inception, a standard market-rate forward FX contract has a fair value of zero ($FV_0 = 0$) because the contracted forward rate equals the prevailing forward market rate for that maturity. Subsequently, at any interim reporting date $t$ prior to maturity, the fair value of a forward contract to buy or sell foreign currency equals the present value of the difference between the contracted forward rate and the current market forward rate for the remaining maturity:

$$FV_{\text{forward},t} = \frac{V_{\text{FC}} \times \left(\frac{1}{F_t} - \frac{1}{F_0}\right)}{(1 + r_{\text{AUD}} \cdot \tau)}$$

Where:

- $FV_{\text{forward},t}$ = Fair value of a forward contract to *buy* foreign currency at date $t$ (in AUD; negative sign indicates a derivative liability, positive indicates a derivative asset; for a forward contract to *sell* FC, reverse the numerator order to $1/F_0 - 1/F_t$).
- $V_{\text{FC}}$ = Notional foreign currency amount of the forward contract.
- $F_0$ = Contracted forward exchange rate agreed at inception (indirect quote: FC per A$1.00).
- $F_t$ = Current market forward rate at date $t$ for contracts maturing on the same settlement date.
- $r_{\text{AUD}}$ = Appropriate AUD discount rate (annualised) and $\tau$ = remaining time to maturity in years (note: where discounting is immaterial or explicitly simplified in short-dated contracts, $\tau \approx 0$ gives the undiscounted value).

## 2.5 Fair Value Hedges vs Cash Flow Hedges (with Worked AUD Examples)

*AASB 9.6.5.2* establishes three hedge accounting models: Fair Value Hedges, Cash Flow Hedges, and Hedges of a Net Investment in a Foreign Operation.

| Feature | Fair Value Hedge (*AASB 9.6.5.8*) | Cash Flow Hedge (*AASB 9.6.5.11*) |
|---|---|---|
| **Hedged Risk Exposure** | Exposure to changes in *fair value* of a recognised asset/liability or an unrecognised *firm commitment* that could affect profit or loss. | Exposure to variability in *cash flows* attributable to a recognised asset/liability (e.g., floating-rate debt) or a *highly probable forecast transaction* (or FX risk of a firm commitment). |
| **Hedging Instrument Gain/Loss** | Recognised immediately in **profit or loss** (or OCI if hedging an FVOCI equity instrument). | **Effective portion** recognised in **OCI** (Cash Flow Hedge Reserve, CFHR); **ineffective portion** immediately in **profit or loss**. |

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| Feature | Fair Value Hedge (*AASB 9.6.5.8*) | Cash Flow Hedge (*AASB 9.6.5.11*) |
|---|---|---|
| **Hedged Item Accounting** | Carrying amount of the hedged item is adjusted for fair value changes attributable to the hedged risk, with that adjustment recognised in **profit or loss** (even for unrecognised firm commitments, creating a firm-commitment asset/liability). | No adjustment to the hedged item prior to transaction occurrence. Cumulative CFHR is reclassified to P&L when hedged cash flows affect P&L, OR removed from CFHR as a **basis adjustment** to the initial cost of a recognised non-financial asset/liability (e.g., inventory or PPE). |
| **Cumulative "Lower Of" Test** | Not applicable (both sides go directly to P&L; net P&L difference is automatic ineffectiveness). | CFHR is capped at the **lower of** (in absolute amounts): (a) cumulative gain/loss on the hedging instrument from inception, and (b) cumulative change in fair value (PV of expected future cash flows) of the hedged item. Any excess derivative gain goes to P&L. |

## Worked Numerical Example 3: Cash Flow Hedge of a Forecast USD Inventory Purchase

**Scenario:** On 1 May 2026, **Southern Appliances Pty Ltd** (an Australian importer, AUD functional currency, 30 June year-end) forecasts a highly probable purchase of inventory from a US supplier for US$1,000,000, expected to take place and be settled in cash on 31 August 2026. To hedge the AUD cash flow risk of USD appreciation, on 1 May 2026 Southern Appliances enters into a 4-month forward FX contract to buy US$1,000,000 on 31 August 2026 at a contracted forward rate of $F_0 = 0.6400$ ( $\text{AUD } 1.00 = \text{USD } 0.6400$, fixing the AUD outflow at $\text{USD } 1,000,000 / 0.6400 = \text{AUD } 1,562,500$ ). The hedge satisfies all *AASB 9* qualifying criteria as a cash flow hedge, designated on the forward-rate basis (disregarding discounting for simplicity).

Relevant market rates (FC per A$1.00) are:

- 1 May 2026: Spot = 0.6450; 4-month forward (to 31 Aug) = 0.6400.
- 30 June 2026: Spot = 0.6180; 2-month forward (to 31 Aug) = 0.6150.
- 31 August 2026: Spot = 0.6250; (forward rate at maturity equals spot = 0.6250).

**Step 1: Inception (1 May 2026)** — Fair value of forward contract is zero; no financial entry required beyond memo documentation.

**Step 2: Balance Date Valuation (30 June 2026)**

- Fair value of forward contract = $\text{USD } 1,000,000 \times (1/0.6150 - 1/0.6400) = \text{AUD } 1,626,016 - \text{AUD } 1,562,500 = +\text{AUD } 63,516$ (Derivative Asset).
- Cumulative change in PV of expected future cash flows of the forecast purchase (hedged item) = $\text{USD } 1,000,000 \times (1/0.6400 - 1/0.6150) = -\text{AUD } 63,516$ (an adverse increase in expected AUD outflow).
- "Lower of" test: $|\text{AUD } 63,516|$ vs $|\text{AUD } 63,516| \rightarrow$ 100% effective! Credit A$63,516 to Cash Flow Hedge Reserve (OCI).

**Step 3: Settlement & Inventory Acquisition (31 August 2026)**

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- Fair value of forward contract at maturity = $\text{USD } 1,000,000 \times (1/0.6250 - 1/0.6400) = \text{AUD } 1,600,000 - \text{AUD } 1,562,500 = +\text{AUD } 37,500$.
- Change in forward contract fair value from 30 June to 31 August = $\text{AUD } 37,500 - \text{AUD } 63,516 = -\text{AUD } 26,016$.
- Cumulative change in expected cash flows of hedged purchase = $-\text{AUD } 37,500$; thus CFHR ends at $+\text{AUD } 37,500$ prior to basis adjustment (100% effective).
- Cash settlement of forward contract: Bank pays Southern Appliances A$37,500 net (or delivers US$1,000,000 in exchange for A$1,562,500).
- Inventory purchase recorded at 31 August spot rate: $\text{USD } 1,000,000/0.6250 = \text{AUD } 1,600,000$.
- **Basis Adjustment (*AASB 9.6.5.11(d)(i)*):** Because the forecast transaction resulted in recognition of a non-financial asset (Inventory), Southern Appliances removes the A$37,500 gain from the Cash Flow Hedge Reserve (not via OCI, as a direct equity-to-asset adjustment) and reduces Inventory carrying cost from A$1,600,000 to A$1,562,500—locking in the exact hedged cost!

| Date | Journal Entry (Southern Appliances Pty Ltd) | Dr (A$) | Cr (A$) |
|---|---|---|---|
| 30 Jun 2026 | Dr Forward Contract Asset<br>Cr Cash Flow Hedge Reserve (OCI) | 63,516 | 63,516 |
| 31 Aug 2026 | Dr Cash Flow Hedge Reserve (OCI)<br>Cr Forward Contract Asset | 26,016 | 26,016 |
| 31 Aug 2026 | Dr Cash at Bank (settlement of derivative)<br>Cr Forward Contract Asset | 37,500 | 37,500 |
| 31 Aug 2026 | Dr Inventory (at spot: US$1,000,000 / 0.6250)<br>Cr Cash at Bank | 1,600,000 | 1,600,000 |
| 31 Aug 2026 | Dr Cash Flow Hedge Reserve (Basis Adjustment)<br>Cr Inventory | 37,500 | 37,500 |

## Worked Numerical Example 4: Fair Value Hedge of an Unrecognised Firm Commitment

**Scenario:** Suppose instead that on 1 May 2026, **Adelaide Wine Exporters Ltd** signed a binding, non-cancellable sales contract (a *firm commitment*) to deliver 10,000 cases of Shiraz to a German distributor on 31 August 2026 for EUR600,000, and simultaneously entered a forward contract to sell EUR600,000 on 31 August 2026 at $F_0 = 0.6000$ ($\text{AUD } 1.00 = \text{EUR}0.6000$, locking in A$1,000,000). Adelaide designates the arrangement as a **Fair Value Hedge** of the FX risk on the firm commitment (using forward-rate changes; discounting omitted for clarity). At 30 June 2026, the 2-month forward rate is 0.6250; on 31 August 2026, the spot rate is 0.588235 ($\text{EUR}600,000/0.588235 = \text{AUD } 1,020,000$).

- **At 30 June 2026:** Since EUR weakened ($0.6000 \rightarrow 0.6250$), the contracted right to sell EUR at 0.6000 is in-the-money. Forward contract fair value = $\text{EUR}600,000 \times (1/0.6000 - 1/0.6250) = \text{AUD } 1,000,000 - \text{AUD } 960,000 = +\text{AUD } 40,000$. Simultaneously, the fair value of the firm sales commitment declined by A$40,000. Both are recognised in P&L:
  - Dr Forward Contract Asset A$40,000 / Cr Gain on Hedging Instrument (P&L) A$40,000.

    - Dr Loss on Firm Commitment (P&L) A$40,000 / Cr Firm Commitment Liability A$40,000.

- **At 31 August 2026:** EUR strengthened sharply to 0.588235 (value of EUR600,000 = A$1,020,000). Forward contract fair value moves from $+\text{AUD } 40,000$ to $\text{AUD } 1,000,000 - \text{AUD } 1,020,000 = -\text{AUD } 20,000$ (a net loss of A$60,000 since 30 June). Meanwhile, the firm commitment increases in fair value by A$60,000 (moving from a A$40,000 liability to a A$20,000 asset):
    - Dr Loss on Hedging Instrument (P&L) A$60,000 / Cr Forward Contract Liability A$60,000 (leaving net A$20,000 liability, settled by paying A$20,000 cash).
    - Dr Firm Commitment Asset/Liability A$60,000 / Cr Gain on Firm Commitment (P&L) A$60,000 (leaving net A$20,000 asset).
    - Upon revenue recognition (*AASB 15*): Dr Cash A$1,020,000 / Cr Firm Commitment Asset A$20,000 / Cr Sales Revenue A$1,000,000—preserving the exact hedged revenue of A$1,000,000!

## Hedge of a Net Investment in a Foreign Operation & Risk Disclosures

An Australian parent with a New Zealand subsidiary faces translation exposure on its net investment in NZD net assets, which flows into FCTR upon consolidation. Under *AASB 9.6.5.13*, the parent may designate an NZD-denominated bank loan or a forward contract to sell NZD as a **hedge of a net investment in a foreign operation**. The effective portion of the gain or loss on the hedging instrument is recognised in OCI (offsetting FCTR in equity), while any ineffective portion goes to profit or loss. Upon eventual disposal of the foreign operation, both the subsidiary's cumulative FCTR and the net investment hedge reserve in OCI are reclassified together to profit or loss.

Finally, *AASB 7 Financial Instruments: Disclosures* requires entities applying hedge accounting to provide transparent tabular and narrative disclosures by risk category—including the nominal amount and average hedged rate of hedging instruments, carrying amounts and line items of hedged items and hedging instruments, cumulative fair value hedge adjustments, CFHR reconciliations (identifying amounts reclassified to P&L vs basis-adjusted), and any hedge ineffectiveness recognised in profit or loss.

## Worked Numerical Example 5: Foreign Currency Borrowing with Accrued Interest

**Scenario:** On 1 April 2026, **Bayside Resources Ltd** (Australian company, AUD functional currency, 30 June year-end) borrows US$2,000,000 under a 2-year fixed-rate USD bank facility bearing interest at 6.0% p.a., payable semi-annually in arrears on 30 September and 31 March. Relevant indirect exchange rates (USD per A$1.00) are: 1 April 2026 spot = 0.6500; Q4 FY2026 average (1 Apr – 30 Jun) = 0.6400; 30 June 2026 closing spot = 0.6250.

- **1 April 2026 (Drawdown):** Loan principal = $\text{USD } 2,000,000 / 0.6500 = \text{AUD } 3,076,923$. Journal: Dr Cash at Bank A$3,076,923 / Cr USD Bank Loan A$3,076,923.
- **30 June 2026 (Interest Accrual for 3 months):** Interest in USD = $\text{USD } 2,000,000 \times 6\% \times \frac{3}{12} = \text{USD } 30,000$. Under *AASB 121.21–22*, interest expense is translated at the transaction/average rate (0.6400): $\text{USD } 30,000 / 0.6400 = \text{AUD } 46,875$. However, Accrued Interest Payable is a monetary liability translated at the 30 June closing rate (0.6250): $\text{USD } 30,000 / 0.6250 = \text{AUD } 48,000$. The A$1,125 difference is an FX loss in P&L:

Journal: Dr Interest Expense A$46,875 / Dr Foreign Exchange Loss A$1,125 / Cr Accrued Interest Payable A$48,000.

- **30 June 2026 (Loan Principal Remeasurement):** Loan principal at closing rate (0.6250) = $\text{USD } 2,000,000 / 0.6250 = \text{AUD } 3,200,000$. Retranslation FX loss = $\text{AUD } 3,200,000 - \text{AUD } 3,076,923 = \text{AUD } 123,077$.
  Journal: Dr Foreign Exchange Loss (P&L) A$123,077 / Cr USD Bank Loan A$123,077.

## Worked Numerical Example 6: Hedge of a Net Investment in a Foreign Operation (*AASB 9.6.5.13*)

**Scenario:** Recall **Tasman Retail Ltd** (Example 2), which owns 100% of Kiwi Outdoors Ltd (NZD functional currency) with opening net assets + goodwill on 1 July 2025 of $\text{NZD } 2,200,000$. To hedge the translation exposure on its NZD net investment, on 1 July 2025 Tasman Retail borrows NZ$2,200,000 from a New Zealand bank and formally designates the NZD loan as a **net investment hedge**. Rates: 1 July 2025 = $1.1000$ NZD/AUD; 30 June 2026 = $1.0500$ NZD/AUD.

- In Tasman Retail's *separate* financial statements, the NZD loan remeasures from $\text{NZD } 2,200,000 / 1.1000 = \text{AUD } 2,000,000$ to $\text{NZD } 2,200,000 / 1.0500 = \text{AUD } 2,095,238$, generating an FX loss of **A$95,238** in Tasman Retail's separate P&L.
- On *consolidation*, because the NZD loan effectively hedges the $\text{NZD } 2,200,000$ opening net investment (which generated an FCTR translation gain of $\text{AUD } 86,580 + \text{AUD } 8,658 = +\text{AUD } 95,238$ in OCI!), the consolidation worksheet reclassifies the A$95,238 FX loss on the NZD loan out of consolidated profit or loss into OCI (Net Investment Hedge Reserve / FCTR): Dr FCTR (OCI) A$95,238 / Cr Foreign Exchange Loss (P&L) A$95,238.
- Net effect on consolidated profit or loss = **A$0**; net effect on consolidated FCTR for the opening net investment = $+\text{AUD } 95,238 - \text{AUD } 95,238 = \text{AUD } 0$, demonstrating complete economic and accounting protection.

## Summary Comparison: Monetary vs Non-Monetary Items Under *AASB 121*

| Balance Sheet Item | Classification | Reporting-Date Rate | Location of FX Difference |
|---|---|---|---|
| Cash, Trade Receivables, Trade Payables, FX Loans, Lease Liabilities | Monetary | Closing spot rate | Profit or loss (unless part of net investment in foreign operation) |
| Deferred Tax Assets & Liabilities; Cash-settled Provisions (*AASB 137*) | Monetary | Closing spot rate | Profit or loss |
| Inventory (at cost), PPE (cost model), Intangibles, Goodwill | Non-monetary (historical cost) | Original transaction-date spot rate | No FX retranslation (only impairment/NRV ceiling tested using closing rate) |
| Prepayments & Contract Liabilities (Unearned Revenue) | Non-monetary (*AASB Interpretation 22*) | Spot rate on date cash was paid/received in advance | None upon subsequent delivery of goods/services |

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| Balance Sheet Item | Classification | Reporting-Date Rate | Location of FX Difference |
|---|---|---|---|
| Revalued Land (*AASB 116*) / Equity Instruments at FVOCI (*AASB 9*) | Non-monetary (fair value) | Spot rate on date fair value was measured | Other Comprehensive Income (bundled with fair value gain/loss) |

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