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FX Hedging of future foreign currency purchases with forwards and changing the cost basis of inventories through hedge accounting

In most of the companies with professional treasury & risk management functions, net (or gross) foreign currency position from business activities are hedged against future foreign exchange (''fx'') fluctuations mostly through forward derivative instruments. Only this way, a company can -healthily- budget the costs and revenues from its future commercial activities in its own functional currency.

When it comes to hedging with derivative financial instruments, longstanding discussion on how derivatives with hedging purposes should be measured on financial statements arises. Its logical to argue that hedging purpose derivatives must be carried at amortised cost ignoring fair value fluctuations since companies are engaged in them not for the purpose of making profits from changes in their fair value (exactly the same reason why the companies carry their receivables portfolio on amortised cost basis).

Although this is a logical argument with sound basis, IASB has always stood firm on its position that all derivative instruments must be carried at fair value no matter for what purpose they are engaged in. The main reason behind such approach is -according to IASB – if such option (amortised cost method) is allowed, it will be impossible to differentiate entities engaging in derivative instruments for speculative purposes and this will significantly impair the main goal of IASB, representing business activities transparently and accurately. There has always been an understanding that, entities with speculative derivatives will hide their real fair value positions from the readers of their financial statements and mislead the overall financial presentation of business environment.

This is why, IASB placed a burden on entities to prove their hedging positions through application of hedge accounting principles. At this point, let's turn back to our theme of this article. We have, say, a Turkish entity which will make a raw material (or commodity) purchase at an amount of 100 USD in three months time. Today USD/TRY fx rate is 5.50. In order to refrain from the uncertainty of USD/TRY rate within the period of 3 months, the entity today engages in a forward transaction and thereby fixes the USD/TRY rate to, say, 6.00. Now our Turkish entity knows that the raw material cost is 600 Turkish Lira, hedging cost is 50 Turkish Lira and will budget its future sale projections healthier.

From IFRS (also Turkish financial reporting standards) point of view, our entity will measure its forward transaction on fair value basis throughout three months, showing in its income statement fair value gains and losses depending on the change in USD and TRY interest rates and spot fx rates. In fact, there shouldn't be such fair value fluctuations since our entity has perfectly hedged its 100 USD payment in three months time with 100 USD receive leg from the forward transaction. So, we come to the point we mentioned at the beginning. Our entity has to prove this hedging activity through hedge accounting application in order to stop fluctuating its income statement until raw material purchase takes place.

If our entity fulfils the hedge accounting requirements in IFRS 9 (risk management strategy and hedging objective manuals and hedge accounting documentation, effectiveness tests, etc.) it will defer these changing fair value amounts under equity (other comprehensive income) thereby refrain from fluctuations on its bottom line result on the income statement. The expected result is clear, whatever the USD/TRY fx rate will be at the end of 3 months, the total payment for the material purchase will be 600 TRY for the entity.

At the end of 3 months period, the entity purchases the material from the market with USD/TRY fx rate, say, 7.00. It will credit the bank account 700 Turkish Lira and debit its inventory account 700 Turkish Lira. So, is the cost of inventory 700 Turkish Lira? What is the fair value of the forward at the end of 3 months and where it will be recognized?

As you can easily calculate, the realized fair value of the forward instrument is 100 TRY at the end of 3 months and our Turkish entity will make a collection of 100 TRY from counterparty of the forward instrument.

In most of the countries' statutory chart of accounts, the gain realized from forward transaction is directly released from equity to income statement as foreign exchange income.

Under former financial instruments standard (i.e. IAS 39) the entities were allowed to choose an accounting policy to either recognize this fair value gain as part of the cost of inventory or fx income in income statement.

However, IFRS 9 does not allow entities to recognize the realized fair value gain as an income item. Therefore, under IFRS 9, the realized fair value of the forward transaction should be added to the cost of related inventory item and this way, cost of inventory should be adjusted. This is called ''basis adjustment''.

Isn't this in line with our treasury/risk management department's initial objective of fixing the cost of inventory at the amount of 600 Turkish Lira? So, the basis adjustment is very important in terms of presenting the real operating results of the entity's commercial activities.

As emphasized many times, entities' international reporting must be in line with their risk management activities. Accordingly, cost accounting basis of inventories and commodities must include the effects of hedging activities implemented by the risk management&treasury departments. Otherwise, the entities' real operating performance will always be blurred by the changes in macroeconomic indicators (i.e. fx rates, interest rates, commodity price changes, etc.) giving outer world a sign of lack of corporate culture and professional business management strategies.