

Not all that glitters is gold - not all that foreign currency what it seems?

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1 Introduction

The financial recession started on the fall of 2008 resulted the trepidation of the financial market in the country due to hectic exchange rates and higher loan payments coming from the weak Forint – loans based on Swiss Frank and Japanese Yen diminished, conditions of foreign currency (exclusively Euro) based loans became strict and the existing portfolio decayed as well, so that the deficit of loan companies increased.

All these changes had not come along with relevant regulatory changes of accounting and taxation rules, giving the conclusion that the current legislation is sufficient and is able to present a reliable, real picture defined by the Act on accounting about the certain economic unit.

According to the accounting approach there is no significant difference between foreign currency and foreign currency based transactions, meaning that rules are the same regarding activation and evaluation. The same stands for asset units' loss of values calculated through evaluation and qualification processes.

In the first part of my essay, I present the magnitude of this problem through statistical data then I review the regulatory changes in evaluation of foreign currency assets from the birth of Act on accounting until present time picturing the assumed and real motivations behind each change.

Next chapter is about the effects of different applied currency exchange rates on business reports supported by simple examples and relating theoretical conclusions, at the same time it highlights the foreign currency positions in the balance and their consequences.

Although typically financial resources could appear in foreign currencies in the balance of businesses belonging under the effect of Act on accounting, receivables could also appear in that. Connected to the last mentioned, the importance of value loss born by foreign currency or foreign currency based assets is significant and raises numerous questions, which I explain by quantitative presentation of two different solutions. In this matter, I emphasize the priorities of annual reports and the effects on business' earnings based on the differences of value loss in foreign currency or foreign currency based transactions including foreign currency position and this way the magnitude of collateral securities.

The thesis studiously deals especially with economic sphere and transactions in between – so that changes referring to foreign currency domestic loans, which I plan to explicate in my next paper, do not influence the information stated in here.

2 The importance of foreign currency loans in light of statistical data

There is almost no heading in financial statements, that would not contain any foreign currency or foreign currency based assets. The most frequent ones are foreign currency deposits, liquid assets, foreign currency claims and obligations especially loan debts and marketable securities. Out of these basic asset and liability units, just right related to them foreign currency evaluation problems could arise also in Provisions, accrued assets and liabilities but in the Tied-up provision within the Equity Capital's unit as well independently whether the particular business has it's bookkeeping in Forint or in foreign currency. The most significant is undoubtedly the foreign currency credit so next I present the order of it.

The balance sheet asset value of credit institutions operating as public limited companies increased from 8.427 billion HUF to 27.520 billion HUF between December 31, 2000 and June 30, 2011 during 10.5 years, which means it tripled. The outstanding loan amount for the same period increased from 4.323 billion to 16.739 billion which is almost a four times increase- meaning that the weight of outstanding loans increased.

Meanwhile the degree of growth exceeded 200% in the case of Forint loans and exceeded 600% in the case of foreign currency, including foreign currency based loans reflecting the increased ratio of foreign currency loans.

The fact that ratio of foreign currency loans made up 37% in 2000 and 68% in the middle of 2011 of the total outstanding loan amount corresponds with the above.

Obviously, this change is greatly influenced by the increase in exchange rates along with the growth calculated in foreign currency, which enhances the dynamics and ratio of foreign currency loans calculated in Forint.

Data of time series on Hungarian Financial Supervisory Authority's webpage are not complete according to this as the foreign currency structure do not appear in those though the whole foreign currency list is a part of the supervisory data supply ,and since then only the Euro appears as main foreign currency, the rest is not included in them.

According the analysis above in case of Euro and Euro based loans, while the summary of Euro loans paid in Euro increased by 10% between December 31, 2006 and 2010, the currency rate increasing by 39% raised the Forint amount of Euro loans by 54%.

It is clear now that it would be necessary to analyze foreign currency amounts to demonstrate the significance of foreign currency loans but since most of the debtors can only pay with Forint cash flow, the change in Forint is also relevant.

The quality of foreign currency and foreign currency based loans worsened due to the recession. The rate of average impairment starting with 0.9% at the end of 2006 (which is equal to 63 billion HUF) increased to 3.3% by end of first half year of 2010 making up 470 billion Forints.¹

For the first sight, the above suggests that foreign currency and foreign currency based loans are widespread in bank sector, which indirectly indicates that how much the importance of it is in the whole economy since foreign currency financing for the enterprises by the banks appears in their passives as foreign currency liabilities.

All these clearly show the significance of proper economical handling of foreign currency assets and sources.

¹ In case of Forint loans, the impairment was far more unfavorable: from 2.2% in 2006, it grew to 7.6% for the first half of 2010. The degree of increase however lags a tiny bit behind the increase of foreign currency loans' impairment, while Forint loans takes up less than a third of total loan portfolio – and there is no special accounting consideration about it since changes in exchange rates do not affect it.

3 Changes in the regulation of accounting²

In this chapter, I only present the changes since the creation of Act on accounting. In my opinion accounting rules in effect before that are less relevant because of the problem's nature and its relation to the economical structure.

First accounting law of our country is Act of XVIII, 1991, which is in effect since January 1, 1992 and its rules regarding the evaluation of foreign currency units remained the same until December 31, 1993. In this period, though it was possible for several commercial banks to sign their own currency rates, the National Bank of Hungary (NBH) signed both selling and buying rates. Consequently, the Act enacts the use of current rates signed by the NBH - in terms of receivables, the buying and in terms of liabilities, the selling rates. First priority of this regulation is the principle of true and fair view, since it is possible to convert the received foreign currency amount in exchange of foreign currency receivables to Forint at buying rate, while the conversion of Forint amount in order to pay for the foreign currency liabilities is allowed at selling rate and this conversion was obligatory for companies in the mentioned period.

The principle of true and fair view was so strong in the Act, so enterprises could not take into consideration in their annual reports the effect of it, they had to present effects coming from the currency rates differences irrespectively of their importance. The same principle was set off in the regulation where the lawmakers distinguished financially settled or not settled headings in the way that in the first case it ordered the application effective actual currency rate during the effective day evaluation.³

Principle of prudence was emphasized along with the principle of true and fair view overwriting the result of the previous enforcement. In case of unsettled foreign currency receivables until the preparation date of balance sheet the law allowed the application of lower, while in case of same liabilities, higher currency rates. As a consequence of higher currency rates resulting the weakening Forint, to settle the foreign currency liabilities in Forint needs more of it when rates go up due to weak Forint, meanwhile the consideration of receivables in Forint decreases due to strong

² In the chapter not all regulations regarding foreign currency items are presented, so for instance the presentation of exchange rate differences to consider in investments' value is left, just like the rules regarding regulations of securities, those ones that are less important from the development of ideas.

³ Principle of true and fair view appeared in the regulation of exchange rates application as well, consequently in case of foreign currency and foreign currency on hand assets, application of different exchange rates was obligatory.

Forint. Both have negative effect on earnings so the presentation of these consequences derived from sticking to the principle of prudence was inevitable.

Starting from January 1, 1994 NBH signed exclusively average rates, so due to the demands of true and fair view and prudence principles, application of buying and or selling currency rates the commercial bank conducting the certain transaction was prescribed “because accounting on NBH middle currency rate valorize incomes and devaluates expenses this way distorts the image of undertaking’s property, financial, income position in annual report.”⁴

This rule precisely reflects the prevalence of foreign currency transactions then, the quality of enterprises’ bank relations and the referring foreign currency rules – e.g. the obligation to offer received foreign currency sum for buying. Nowadays, since the affected enterprises are neither partners of one bank, nor making only few transactions annually, a rule according which each transaction has to be evaluated on the particular financial institutes’ currency rates, would result huge chaos.

In 1995, it became clear that financing in foreign currency has a negative effect on financial statements of enterprises resorting it because lacking the possibility of valorizing the assets, the valorization of sources⁵ directly appeared as earning decreasing factor.

First modification of Act on accounting has not changed the evaluation rules of foreign currencies that time. The lawmakers insisted on that “the accounting of unrealized loss on exchange creates the financial conditions of payback in case of the loss presented in the profit and loss statement could be earned (or set off) in couple of years”⁶.

The increasing currency rates, meaning the weakening Forint, and the loss on currency appeared simultaneously with the valorization of liabilities were no surprises neither for the lawmakers nor for the enterprises: since February 1990 in the following 5 years, the Forint was devaluated altogether 23 times without any previous announcements. From 1995, it was devaluated with previously announced rate in every workday i.e. the sliding currency rate system was introduced.⁷ First step was a 9% Forint devaluation in the spring of 1995, and then -gradually decreasing by months - devaluation had been introduced. In line with it, the zone of currency rate range was

⁴ General explanation to the Act CVIII, 1993.

⁵ “In the last 5-6 years foreign currency rates increased due to the devaluation of Forint, in case of Dollar and German Mark with annual average of 15%, in case of Jen with 27%.” Source: General explanation of Act XX, 1995.

⁶ General explanation if Act XX, 1995.

⁷ There was devaluation in the previous period as well, but unexpectedly as time and degree.

broadened so the central bank intervened only when the difference reached $\pm 2.5\%$ at the end of 1995 instead of $\pm 0.5\%$ at the beginning of 1994.⁸

Instead of reducing the effect of unrealized currency rate loss on earnings and on Equity Capital, the modification of Act on accounting being in effect from 1995, created the possibility of valorization of assets through Equity Capital⁹, supporting to fulfill the criteria made by the Act on Business Associations. Explanation of modification of Act was not the currency rates but the inflation, which indirectly means that the inflation was thought to be a consequence of the weakening Forint.¹⁰

Currency rates increased due to the sliding devaluation – at the end of 1995, currency rate of German Mark exceeded 36%, American Dollar 22% comparing to the previous year's rates. In most of the cases, real estate prices could not express this change entirely, so the correction of values by the method of creating an evaluation reserve bond to it was not enough sufficient to compensate foreign currency loans' currency rate losses, that's why the lawmakers made it possible to spread the unrealized currency rate loss in between the next periods. The solution to eliminate accounting effects of future devaluation was that the already accounted unrealized currency loss turned out to be deferred while "it had to be determined, because of the expected... currency rate loss, how much Provision enterprises need to have at the end of each year during the duration of loan".¹¹

This way the sum of currency rate loss accounted each year during the tenor of the loan was near to even, had not resulted peak in effects of earnings.

Along with the change described above, a new rule appeared from January 1, 1997 claiming that presentation of currency rate differences is not obligatory if "the effect of evaluation on assets, liabilities denominated in foreign currency or foreign currency holdings on hand and earnings was not significant or was expected to balance in the next year."¹²

Further modification in evaluation of currency headings has not come into effect under the Act XVIII, 1991 however the Act on accounting was freshly encoded in 2000, so

⁸ Krisztina Terbe: Variations in Forint exchange rate in the '90s and the sliding currency rate in Hungary

⁹ Value Correction and Valuation Reserve in Equity could be created when the market value of evaluated assets exceeded their net book value.

¹⁰ Devaluation affects inflation as well through the more expensive import, however that is not the only explanation to it – but explanation of the act does not aim to enlighten all relationships, so it is not the fault of the certain text

¹¹ General explanation of Act CXV, 1996.

¹² Act XVIII, 1991, §31 (3) – entered into force January 1, 1997.

its structure has changed meaning that the rules for evaluation of currency headings have been modified.

According to the Act C, 2000 about accounting the evaluation became simplified from January, 2001: the lawmakers have not regulated to handle the assets and liabilities in foreign currency separately on the effective day depending on whether they had been paid or not until the preparation of balance sheet and the consideration of assets and liabilities denominated in foreign currency or foreign currency holdings on hand on different rates, is not obligatory anymore.

In my view, the most important change was the extension of applicable currency selection and the enactment of their order. The new law, by breaking the current rule ordering the application of buying and selling exchange rates which holds to the principle of true and fair view, enacts the application of primarily NBH's or chosen own bank's average rates. It provided that enterprises could deviate in case there is a need of it to picture a true and fair status, but in practice, only a trace of enterprises chose that because it came along with lots of extra duties. Comparing to the application of average exchange rates, to demonstrate the difference born by applying buying or selling rates was possible through double evaluation.

Lawmakers waived the application of more real rates according to official justification, because "the analysis on bias coming from buying or selling exchange rates concluded that the difference is not significant from the application of rates' side. The effect of law on earnings balances out in the conversion between Forint and foreign currencies and in reverse, prior to then it is negligible."¹³

Detailed results and basic data of analyzes supporting this argument have not been available for me, so in the next part I briefly explain the reliability of this justification.

The version of Act on accounting being in force since 2001, has been bearing in mind the principle of prudence, this way making it possible to defer the sum of unrealized gain due to annual reports. At the same time, it kept the concept of accrued exchange loss consequently the formation of provision as they previously were.

The rule mentioned last is included in the current accounting act, however it was not always so: the Act CXII,2005 repealed paragraphs referring to it from January 1, 2006, then entered them into force unchanged in the Act CXXXI, 2006 from January 1, 2007 claiming that they could be applied for the reports of 2006. As result of timing in legal amendments, the unrealized exchange difference became deferrable during the lifespan of the act.

¹³ Explanation to the Act on accounting C 2000, General part

Justification of Act, 2005 does not mention the reasons of the repeal at all, and the Act, 2006 points exchange rates' fluctuation as a reason of reentering the act into force. The figure demonstrates well that, rates of the two relevant (CHF and EUR) foreign currencies did not seem especially volatile in the certain period -rather a leveling is detectable. Probably lawmakers thought that it is time to delist the application of deferrals and provision forming (a new accounting estimation). During 2006 exchange rates varied, the relative deviation was 3.5-4% in case of 4 analyzed foreign currencies meaning for example that in 2006 the average rate of Euro was 264.27 HUF/EUR, the highest rate was 282.69 HUF/EUR and the lowest was 249.55 HUF/EUR. The peak in rates occurred in the period from June to September, this way the "re-correction" of evaluation rules was possible.¹⁴

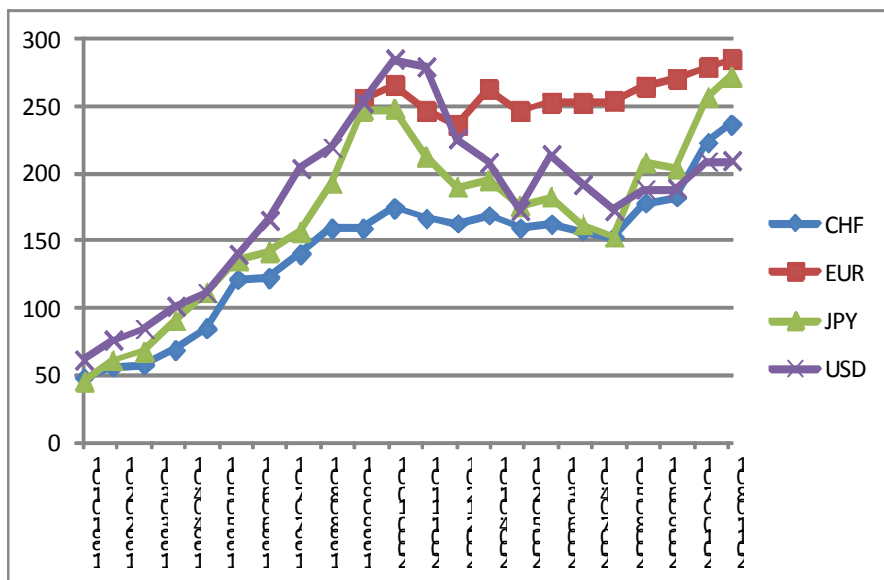


Figure 1.

Exchange rates 1991-2011 (Source: mnb.hu)

¹⁴ In my view such modification of rules – depending directly on exchange rate fluctuation –, basically questions that whether the principle of act on accounting to the true and fair picture could be realized.

The act on accounting being in force at time of preparation of the article includes the previous rules but there is also an important modification referring to two areas.

First from 2011 –also applicable to 2010- it is not obligatory anymore to introduce the difference derived from administration of the two preferred exchange rates (NBH's and own bank's average rates). On the other hand, it became possible to account the difference derived from exchange rates regardless of limitation.

4 Positions of foreign currencies in the balance sheet

The first act on accounting was based on that the enterprises regulated by it use the Forint as functional currency, operating domestically, have their expenses typically in Forint but partially have their earnings from abroad and the gained foreign currency is later used by them again domestically. In this period, at the beginning of 90s, the obligation to convert foreign currency incomes to Forint supported this approach.

Since all incomes and cash of enterprises were available in Forint, they could attain foreign currency sum by buying it out of Forint.

Banks applied buying rates for the conversion of foreign currency to Forint while selling rates for purchases out of Forint and this practice was implemented into the legal regulation.

From the middle of 90s, steps towards the liberalization of foreign currency regulation allowed in gradually extending degree and sector that enterprises do not need to convert foreign currency incomes coming from sources determined in legal regulation to Forint. This way, in case they wanted to use it in foreign currency without conversion and loss in connection of it, they were free to do that. This possibility changed the financial statement prepared according the act on accounting that was supposed to reflect "reality". The overall foreign currency liberalization¹⁵ along with the further applications of different rates to assets and liabilities related to it, would

¹⁵ Act XCIII, 2001 made the total liberalization possible, for the preparation of it, they broadened the intervention zone in March, 2001, which was $\pm 15\%$ from this time until it was terminated in February, 2008, although the pre-announced sliding devaluations were terminated already on 1st October, 2001. (Source: <http://www.mnb.hu/Statisztika/statisztikai-adatok-informaciok/adatok-idosorok/vi-arfolyam/ftleert-2003>)

have been improper – it became clear that lawmakers could require application of only one exchange rate in the annual report.¹⁶

The following unanswered question is what this exclusive rate should be. Next, I explain the background required to this decision.

In case of enterprises that possessed both foreign currency assets and liabilities, following the implementation of free economical management of foreign currencies, the foreign currency risk (possibility of earning modification due to exchange rate differences) appeared in open position in the annual report¹⁷, i.e. in the difference between assets and liabilities in the particular foreign currency. As long as the foreign currency assets had exceeded the liabilities, the exchange rate increase resulted in gains, otherwise in loss in the report. When the foreign currency assets were the same as the liabilities, the exchange rate difference did not alter earnings and in case of small asset-liability difference, this effect was not remarkable.

Lawmakers during the creation of Act C, 2000 took the assumption that enterprises not only aware of foreign currency positions in their balance sheets but consciously and effectively manage them through assets set-up¹⁸ within the report.

At this time, application of NBH's or banks' own average rates serves the purpose since the exchange rate difference is not significant¹⁹ i.e. any rate could be proper for the evaluation.

In case of foreign currency surplus amount on the assets side, the exclusive application of buying exchange rates, otherwise the exclusive application of selling rates would reflect the reality. Lawmakers has made and still make the application of these rates compulsory for enterprises –however until 2010, it was complicated because they had to present the difference in profit and loss calculated by the application of the two previous exchange rates.

¹⁶ This also means that the explanation of Act C, 2000 reflects not the actual motivation but its superficial version, even if it is relevant from the applicable exchange rates' sides.

¹⁷The open position is calculated data in the balance sheet, but in case the enterprise has off-balance sheet assets and/or liabilities, those also have to be included in position calculations.

¹⁸ In case of surplus at liability side, the conversion of Forint assets to foreign currency, or the conversion of foreign currency to Forint could be a hedge appearing in the balance sheet. The effect of the above directly appears – through the balance sheet – in the financial statement, while in case of hedging with derivatives, their effect reflects only in the profit and loss statement.

¹⁹ Here I do not use the term significant in the meaning of act on accounting.

In the consequence of this obligation, enterprises especially those that were not obligated to audit books²⁰ have not really applied this regulation of act on accounting. However, they applied for loans to the banks and they submitted data about their financial and earnings position to client qualification. Banks handled and still are handling well accounting data, not really representing reality, and since loan-taking enterprises had foreign currency gains on liability side, banks converted these liabilities to Forint not at NBH-rates rather than at the selling rate of loan issuer and they took into consideration that rate during the financial standing process. This process is understandable in cases when in financial statements the cover of foreign currency loans expressed in Forint is in asset side, since in order to pay them back, a conversion is necessary.

In this case, there is no foreign currency item in the asset side of the balance sheet while in the liability side there is the foreign currency liability. According to the balance sheet, the enterprise has an open position, which represents a foreign currency risk to it, so this way leaving the risk factor untreated, the financial statement will show foreign currency gain and loss in case weakening of Forint.

Besides the problem above, there is another one when the cover of foreign currency or foreign currency based liabilities is the future incomes in foreign currency as well. In this case, there is no open position financially or its degree is not the same calculated according to the balance sheet. Accordingly, these enterprises are deadlocked.

When they have their income in foreign currency²¹ typically, they will be able to settle their due foreign currency debt payments out of those, so they nor will have exchange losses, but they do not have the ability to make gains neither.

Accounting could have theoretically two solutions to solve this²²: either to consider the effects of future expected foreign currency incomes on exchange earnings in advance, or to decrease the financially unrealized exchange loss produced during the reevaluation of liabilities.

The first solution raises several problems that I explain through the next example:

Example 1: Problems with future foreign currency incomes

²⁰ This statement primarily reflects my faith in accounting profession according to I assume that the reports audited, support the true and fair view in every case.

²¹ Such enterprises are e.g. international shipping transporters.

²² Purpose of accounting is certainly not the handling but the presentation of risks. These enterprises got into the situation when their risks are exaggerated in their financial statement prepared according to the accounting rules, that's why accounting regulations have to be adjusted to the reality.

A logistic company signed a 3-year contract with its partner from the EU according which it does logistic work for it in at least 100.000 EUR value per month. In order to do the job it bought cargo vans for credit in 2500 EUR value, the full term of credit is the same as the duration of the contract and the sum of Cash Flow to pay is 10% less than the expected Euro income.

Foreign currency solely appears at the liabilities in the amount of credit as 2500 EUR on the balance sheet of the logistic company. According the accounting rules, the exchange rate difference should be registered in the earnings annually.

However, in practice there will not be formed any exchange rate difference, if the contract entirely realizes.

The realization of the contract depends on several factors: Will there be order placed in this amount? Does the partner pay reliably? Does the contract last for 3 years or ends sooner?

There has to be a solution for this problem not only from accounting side, but it also creates a decision-making situation in the enterprise which has to find answers to these questions if it wants to reduce the risks. It has to decide how much of Cash Flow it should consider at the asset side determining the foreign currency rate position, which practically means the set of discount factor that reflects the time-value of money and the uncertainty of future incomes.²³

From accounting part, there is a solution to set the due date present value of all future cash flows according the most likely outcomes of Cash Flow at the asset side, and according this result to register a potential gain, maybe as accrued income on the balance sheet.

This solution is not accepted yet especially in the national regulation emphasizing prudence, however current modifications and proposals of IFRSs require the consideration of similar aspects²⁴.

The Hungarian regulation of accounting has given a solution to this problem from 1995. This answer is being in force since then²⁵, and enterprises could administer it for 16 years though I do not have reliable information about its frequency.

²³ Methods of determining position in such cases and applicable hedging strategies will be discussed in my next paper.

²⁴ I list here the modifications of IFRS 9 being already in force, and the layout of leasing standards that is intended to come into force instead of IAS 17 to this point.

²⁵ The detailed regulation has changed many times, lawmakers considered experiences gained through practice, and made corrections.

The solution made it possible to defer the unrealized exchange loss of liabilities hoping that a future exchange gain will balance it. Certainly, the problem is the same with that I explained at the asset side: when and in what degree will the deferred exchange loss be returned? The act on accounting does not try to solve this problem instead it requires the administration of a simple accounting estimation (realizing the time-tailored loss) according that it adds an independent item–provision- into the passive side of the balance sheet.

The “beauty spot” of this solution is that lawmakers did not lay down any condition. Application of it does not require any contract from undertaking aiming future foreign currency gains, any enterprise could apply that in case there is a need for it because of the capital situation or from the part of the owners’ earning expectations. Even though this implementation seems to be right to reflect financially closed, but accountably open foreign currency position in reports, it overshoots the mark because it makes enterprises able to amend earning fluctuation where there is no financial reason for it at all.

5 Foreign currency or foreign currency based?

The foreign currency law (Act XCV, 1995) and the 88/2001 (06.15.) directive about its enforcement eliminated limitations of conversion of national currency from June 16, 2001. According the regulations along with that the Forint became convertible absolutely, economic entities could pay their liabilities to one another in foreign currency. This regulation was repealed from January 1, 2002. From this point Act XCIII, 2001 about elimination of foreign currency limitations makes it possible for domestic foreign currency users meaning enterprises to pay for their liabilities to one another in foreign currency as well, so not only the calculation itself but the linked invoicing and cash flow should also be in the same foreign currency .

Act C, 2000 about accounting to react to the changes above, lays down in its §60 (7) that “if the law allows for domestic foreign currency users to define considerations and their installment on the basis of foreign currency in their contracts, then according these contracts, paragraphs (1)-(6) have to be applied in registration and at the balance sheet date evaluation”.

Consequently, the law does not distinguish the evaluation of exclusive foreign currency or foreign currency based transactions in the financial statement. In this

section, I analyze how strong this approach is, how the report prepared this way could show a true and fair picture about the enterprise made it.

In case of foreign currency based deals, liabilities of a company are denominated actually in foreign currency, in spite the creditor expects payments in Forint not in foreign currency. At this point, the enterprise has foreign currency receivables but it is not able to pay for its foreign currency based liabilities directly only after conversion to Forint. This is double burden for it: the conversion to Forint is on buying rate and for payment it is on selling rate, so the difference created this way is clearly the burden of the enterprise.

All these mean that enterprises had to and still have to make responsible decisions about the foreign currency type of their financial liabilities in their calculations and payments. In case they have actual foreign currency income, it is recommended to apply for real foreign currency loan, which calculated in foreign currency and requests payment in Forint the same currency, instead of foreign currency based one. If they do not follow this, they will have open position in cases of both receivables and liabilities denominated in the same foreign currency and in the same amount, consequently they could have even exchange earnings. I explain this through the next example:

Example 2: Problems with foreign currency based liabilities

An enterprise has a 100 EUR receivable from a client who will pay for it in Euro. It will finance it from a loan, which it has to settle in Forint on the bank's selling rate.

At both asset and liability side of the balance sheet, the enterprise has 100 EUR so according to the rule there is no exchange earning expected.

At the time of receiving the 100 EUR liability the buying rate of the financing bank is 250 and the selling is 260. The enterprise sells the incoming 100 Euro to the bank and receives 25.000 HUF for it. The payment for the creditor is $100 \text{ EUR} \times 260 \text{ HUF/EUR} = 26.000 \text{ HUF}$ - so that the debt cannot be settled. Consequently it will not have foreign currency at the asset side but will have 10.000 HUF debt at the liability side – typically not in foreign currency, since banks at due date often convert debt to Forint. If in the sense of loan contract, the bank registers liability still in foreign currency, it means 3.84 EUR (10.000/260). In the first case, there is no difference on exchange though there is a need for extra source to pay off the loan, and in the second case, the exchange rate risk is still on, so exchange earning appears.

The consideration above requires that foreign currency based and exclusive foreign currency items have to be separated at the determination of foreign currency position

based on the financial statement, and in order to make a financially closed position, they do not need to be absolutely same rather than there has to be some surplus at the asset side.

The question is, how this surplus amount could be determined or could it be determined at all.

As we could see in the 2nd example, the amount of liability, produced by the conversion of foreign currency receivables ($250/260 \times 100 \text{ EUR} = 96.15 \text{ EUR}$), could be determined in the view of the ratio of selling and buying rates, this way the amount of loss as well. The execution of this calculation becomes complicated because the due dates of receivables and liabilities are often different, the enterprise is connected to not only one bank so that to determine the applicable exchange rates is uncertain. In case this uncertainty reaches or exceeds the level of potential exchange risk derived from the theoretical approach above, execution of it turns out to be unnecessary, moreover harmful.

The problem above could be interpreted in another way: in case of foreign currency based receivables and exclusively foreign currency liabilities, the risk derives from the difference between the rates (in the contract) applied to convert the receivable to Forint and the selling rates of the bank running the payments. There are typically rather contracting than accounting methods to prevent this – to convert foreign currency receivables, selling rate on due date is the generally applied rate this way the exchange risk is out of question.

Example 3: Problems with foreign currency based receivables

An enterprise has 100 EUR receivables from a client who will pay for it in Forint. It will finance it from a loan, which it has to pay off in foreign currency.

At both asset and liability side of the balance sheet, the enterprise has 100 EUR so according to the rules there is no exchange earning expected.

a) According to the contract, the client is obligated to pay the liabilities on buying rate of the financing bank, which is 250 HUF/EUR. The enterprise converts this incoming 25.000 HUF (=100 EUR×250) to foreign currency on selling rate (260 HUF/EUR) of the refinancing bank and it becomes 96.16 Euro for it which is not enough to settle the foreign currency debt.

b) To settle the whole amount to the creditor it needs 100 Euro×260 HUF/EUR=26.000 HUF, which

*could be available in case the payable Forint amount is assigned by the application of foreign currency selling rate in the contract.*²⁶

Notice, that there is no exchange risk at the Example 3, b) not even when the refinancing liability is exclusively foreign currency. This time the proper amount of foreign currency for payment could be obtained from the Forint amount on selling rate for the liabilities.

In the previous chapter, enterprises with open foreign currency positions according the balance sheet were analyzed – typically having surplus at the liability side meanwhile having continuous future foreign currency income according to their contracts.

In this chapter, we analyze the same situation with the difference that future incomes are expected not in foreign currency, but on foreign currency basis, in Forint.²⁷

The possible solution – to realize the certain amount of expected exchange gain in advance – described in the previous chapter is also applicable here, with the restriction that this solution assumes the definition of income conversion on selling rate in the contract as well.

6 Annual report and impairment

Connected to the foreign currency liabilities, beyond usual questions regarding loss in value, the exchange rate to apply and the priority of annual foreign currency evaluation have to be defined in the annual evaluation.

According to the accepted widely taught and published view²⁸, the first step is to determine the loss in value in foreign currency in case of foreign currency liabilities,

²⁶ These types of contracts are signed typically by those financial enterprises that finance their outsourcings not of their own incoming Cash Flow – since they do not have the right for cash collection – but of the refinancing loans, they got from commercial banks. Since the effective financing and installment happen in Forint, even if foreign currency based, the financial enterprise applies for the same loan from the financing bank.

²⁷ Typically, these enterprises are e.g. the office buildings, which can pay their installment of foreign currency based loans taken for the construction, from their future Euro based rental incomes.

²⁸ This opinion appears in the 1.4 Chapter of Hungarian Accounting Chamber's accounting educational publication as well. Author: Jozsef Roth Dr.

which is followed by registration on book rate. The last step is the revaluation of foreign currency amounts including both the original receivables and the registered impairment.

Analyze these in the following example:

Example 4: Problems with foreign currency based receivables

An enterprise has 100 EUR receivables from a client who will pay for it in foreign currency. The receivable was registered in the books in the current year on 250 HUF/EUR book rate. From the receivable there is no 10% return, which is the 255 HUF/EUR rate applied at year-end evaluation.

According to the recommended solution, 10 Euro impairment has to be registered on book rate, so 2.500 HUF (=10 EUR×250 HUF/EUR) appears under other operating expenses. Following this, the net bookvalue of receivable will be 90 EUR, the revaluation difference of it will be 450 HUF (=90×(255-250)), which appears under the other income from financial transactions – if the summarized exchange rate result is a gain, while under other expenses in case of summarized loss.

In the next year the value of receivables in foreign currency does not change, because of that the booking of 50% impairment was necessary, and the rate was 260 HUF/EUR at the end of the year.

Consequently the sum of additional impairment: 10.200 HUF (+40×255 HUF /EUR, so we define increment in Euro on book rate, in this case the one used at revaluation at the end of previous year). Next step is the revaluation of the remaining net foreign currency receivable (50 EUR) resulting appearance of additional 250 HUF exchange gain.

To sum up the above:

Category	1 st year	2 nd year
Impairment (other expense)	-2.500	-10.200
Exchange gain	450	250
Summarized effect on profit and loss	-2.050	-9.950

The method considers impairment as a foreign currency item, just like the receivable itself that was impaired.

In my opinion, this consideration is well established from the side of financial reality as well: when the payment of a receivable becomes doubtful, we “waive” - not legally - the estimated unpaid part by booking impairment, so we realize its loss. Conclusion also means, that in the future we do not wish to have further losses concerning this impairment - in the example concerning 10 and additional 40 Euros. Exchange rate change would cause such a loss, that we would like to exclude this, so we take into calculation this impairment at the asset side of the balance sheet decreasing the position.

The solution above only partially reflects the last way of thinking. On one part, it is according to the principle since only the net receivable is revalued after registering the impairment, so additional exchange earning does not appear in the books.

On the other hand, impairment was booked according a previous book value, which contradicts the principle of true and fair view: the impairment loss is born on the day it is registered - at least based on the financial thinking - so according this, the registration of it should not be on a past rather than a present rate.

At the same time, I have to tell that applying past exchange rate absolutely suits the principle of going concern as the basis of act on accounting. The evaluation on cost value of assets is the consequence of this principle and as result of it, we register assets on their original prize until canceling. This approach is overruled at several points by the law even in case of enterprises not applying fair value measurement. On one hand it allows to “appreciate” assets by value correction, on the other hand it makes booking of impairment obligatory not only in case of receivables but in case of tangible assets and inventories as well, if their book value permanently and significantly exceeds their market value.

However the law makes an exception in case of foreign currency asset parts because of their nature, the volatility of exchange rates and the handling method of risks in them, it prefers the principle of true and fair views meaning the application of due date rate.

Since marking impairment is a duty related to the periodical closing, the cost value should be the due date exchange rate. Analyze the effect of recommended method through the last (4.) example.

According to the proposed solution, first the gross receivable has to be revalued, as a result a revaluated difference of 500 HUF ($=100 \times (2550 - 250)$) appears in the earnings of financial transactions. After this could the 10 Eur impairment be accounted, now on due date rate, so that 2.550 HUF ($=100 \text{ EUR} \times 255 \text{ HUF/EUR}$) appears under other expenditures.

In the next year the value of receivable in foreign currency does not change, because of that the accounting of 50% impairment was necessary, and the rate was 260 HUF/EUR at the end of the year.

As result of it, in the new annual revaluation there is an additional 450 HUF ($=90 \times (260 - 255)$) exchange gain marked, and the sum of impairment to mark is 10.400 HUF ($+40 \text{ EUR} \times 260 \text{ HUF/EUR}$).

To sum up the above:

Category	1st year	2nd year
Impairment (other expense)	-2.550	-10.400
Exchange gain	500	450
Summarized effect on profit and loss	-2.050	-9.950

It is clear, that although certain factors of the result had changed, the solution above leads to the same conclusion as the commonly accepted method.

In my view, the second solution reflects the situation better, and it is more consistent since according to it, the impairment is booked always on daily exchange rate, while in the first case either on original rate or on any later balance sheet date rate, if the receivable had been still in the books for more than a year.²⁹

Reserve due to the uncertainty of receivables has to be booked as negative signed item – impairment – at the asset side of the balance sheet. This have not always been so; even in the history of act on accounting, there was a solution that required not the reduction on the asset side, but the appearance of a new item on the liability and equity side of the balance sheet, called provision. In this case, the exchange rate of creating a provision was obvious since it was about booking a new passive, which has to be registered not on an exchange rate of an already existing asset, but on the actual daily rate.

Impairment booked on foreign currency receivables is also in the same currency, hence it is taken into consideration at the determination of foreign currency positions –

²⁹ In the first example, the impairment created in the year when the receivable was booked, appeared in the books on rate 250, while the next year impairment appeared after the first revaluation, that's why it reflected the particular daily rate. In case the enterprise choose to make monthly revaluation – which could legally do that, and according to regulations of its parent company, usually its obliged to – we almost reach to the second solution.

this way creation of impairment affects the position, which reflects in the books as well.

The question is that, whether this point of view should be applied also in case of foreign currency based transactions.

There are foreign currency based transactions where the applicable exchange rate is laid down in the contract, but the due date of the conversion is not, so it could not be determined in advance on what exchange rate should the installment be converted to Forint, meaning that the particular amount of foreign currency is indeed a foreign currency until paid. This means that the evaluation of this type of foreign currency based transactions – including the description at accounting of impairment – is the same as it settled at exclusively foreign currency transactions.

At another type of foreign currency based transactions – as I claimed before – the contract could possibly contain the day when exchange rate on that the debtor is obliged to pay the converted Forint amount. In case of such foreign currency based transactions, it turns out to be a Forint receivable on exchange rate of due date – typically on selling rate. This solution results that such receivables are not actually foreign currency ones, at due date or at the end of their term, they become to be determined in Forint. Consequently, from their conversion time their impairment is also not in foreign currency but in Forint. To prove my statement, here is the following example:

Example 5: Loss in value of foreign currency based receivables

An enterprise gave a 1000 EUR foreign currency loan to one of its partner. Half of it is due on 30, October, and the other half is due 30, April in the next year to the due date, in Forint. The cost value rate is 250 HUF/EUR, the selling rate at due in October is 260 HUF/EUR, at annual evaluation it is 265 HUF/EUR, and at the final due date it is 254 HUF/EUR. The enterprise refinances the transaction out of a foreign currency loan, with the same timing as the timing of the asset side's item. The enterprise creates a 20% impairment for the future balance sheet date 500 EUR receivable since the debtor paid the first installment 50 days overdue.

In case the impairment created in foreign currency, the open position of the enterprise determined by the financial statement according to the act on accounting will be the following:

Assets: 500 EUR receivable due in the future- 40 EUR impairment,

Liabilities: 500 EUR liability, due in the future.

The enterprise had not had an open position before the creation of impairment, the value of Euro assets and liabilities was the same. The position virtually opened by registering the impairment, and the enterprise got into the exchange risk that it wants to avoid. According to the book that reflects the financial reality, the position has not opened since it can expect still 500 EUR revaluation difference from the debtor as the contract says. In case of the receivable is lost indeed (cancellation, factoring), the Forint amount due is calculated on actual selling rate, this way there will be no exchange loss, instead the credit loss increases.

In case of hedging a seemingly financially open position on due date exchange rate, it means that it fixes the rate of the generated 40 EUR impairment so that it surely realizes 10.600 HUF loss. In case it converts the receivable to Forint on due date on 254 HUF/EUR rate, it becomes obvious, that the hedging transaction, according to the year-end impairment estimation, was unnecessary, because that did not avoid exchange rate risk, but brought it into the operation of the enterprise.

In point of this unsettled 500 EUR, the enterprise did not have any exchange risk – the hedge built into the credit transaction.

The deduction above attracts attention to that though basic receivables of foreign currency based contracts have to be evaluated in the balance sheet at the determination of foreign currency position – which's starting point is usually the accounting data- in the same way as exclusively foreign currency receivables, impairment of these transactions has to be handled separately.

7 Summary

The article proves that accounting rules of foreign currency asset items follow the changes of economical environment and changes of enterprise reality determined by it – they try to answer properly the revealed problems by the modification of rules.

The answers could be supported in different degree with theoretical considerations. While in the case of applicable exchange rates, the updated act on accounting is acceptable and reflects reality, the separation of not realized exchange loss seems to be a partial solution.

It is proved that the same handling of foreign currency and foreign currency based transaction does not distort the true and fair picture, but direct application of it in the determination of enterprise foreign currency positions could be misleading – respectfully to the impairment of foreign currency based transactions.

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