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How Foreign Exchange Currency Transactions Impact Your Business

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Have you ever looked at a foreign invoice and wondered how shifting exchange rates might affect your business's bottom line?

If your business – especially in the manufacturing or wholesale industries – imports or exports goods, you've probably encountered this situation before.

The intricacies of foreign exchange (FEX) can be daunting. But with international trade becoming the norm, it's essential to know how currency fluctuations affect your bottom line – not just for the accountants or finance team members, but for business owners and senior management too.

In this blog post we explore the mechanics of how foreign exchange currency transactions work, how unrealised and realised foreign exchange values impact your business, and most importantly, why we believe you should include that value in your gross profit calculations.

The Mechanics of FEX Currency Transactions

To understand how foreign exchange realised and unrealised gains or losses occur within a finance system and how the transactions work, we'll use two different examples.

How Unrealised & Realised FEX Gains & Losses Work

Scenario 1: A Foreign Exchange Loss

Imagine it's the August 10th and your manufacturing business has purchased goods from an overseas supplier. You've received the invoice for $10,000 in the foreign currency with 30-day payment terms. The day's exchange rate of 0.71 equates to

$14,084 in local currency value.

The first transaction is to debit the expense or the stock account and credit the creditor. At this point, there is no impact on our foreign exchange. As the invoice is unpaid, the transaction is unrealised.

Solid accounting practices demand that foreign exchange values are re-evaluated at the end of every month. To illustrate what happens next, let's fast-forward to the month's end.

It's now August 31st and the invoice remains outstanding. The day's foreign exchange rate has dropped to 0.69, making the dollar less powerful. Your once $14,084 liability now stands at $14,492, a difference of $408. This resultant gap between the prior invoice transaction value and current transaction value means effectively you now owe the creditor more money.

The transaction is to credit the trade creditors $408 and debit the unrealised foreign exchange gain or loss:

- Debit = To recognise the liability.
- Unrealised = Because the invoice remains unpaid.
- Loss = Reflecting the exchange rate has decreased your dollar's value.

The next day, September 1st, the unrealised foreign exchange gain or loss that occurred is reversed. This is because all transactions are maintained at their original value until the transaction is realised. The transaction is debiting the trade creditors and crediting unrealised foreign exchange gains or losses. Therefore, the $408 is returned.

Now it's September 10th and the invoice is due. The exchange rate has lifted to 0.70. Your final invoice value is now $14,285, but the creditor is sitting at $14,084. The transaction is to credit the bank for the $14,285 and debit the creditor to pay the invoice of $14,084. The resultant gap of $201 is a foreign exchange loss, hence a debit, and becomes a realised loss when the money leaves your bank account.

Scenario 2: A Foreign Exchange Gain

What if the currency gods were smiling on September 10th, and the exchange rate had jumped to 0.73?

If this occurred, the final invoice in local currency means you'd only need to pay $13,699. You still debit the trade creditors for $14,084. With only $13,698 to pay, you offset the trade creditor $14,084, and the resultant gap of $385 is a foreign exchange gain, which is realised.

Key takeaway: The gap between values when invoices are issued and paid can lead to gains or losses based on prevailing exchange rates. Monitor your foreign exchange transactions closely, and re-evaluate values at each month's end.

Navigating Prepayment Dilemmas

In some cases, international suppliers might demand payment even before you receive an invoice. What happens if you make the payment first? Here, the dynamics change slightly. Let's suppose the dates as per above remain the same.

On August 10th, a foreign transaction worth $20,000 at an exchange rate of 0.56, this translates to $35,714 in local currency. The initial transactions are debit supplier deposits and credit cash in bank.

At the month's end, you haven't received an invoice nor made any further payments. The initial $20,000 deposit value remains. But suppose the dollar has strengthened, lifting the exchange rate to 0.57. The deposit is now worth $35,087 in local currency. The difference of $626 of means on August 31st the transaction is to debit to an unrealised foreign exchange loss account and to offset that with the supplier deposit account.

Like in the prior scenario, the next day is September 1st. Here, there's a reversing transaction for $626 to bring the total deposit value in line with the current value.

Fast-forward to September 10th and you've received the invoice for $20,000. The daily exchange rate is now 0.55 – meaning your currency is more valuable – and the final transaction is worth $36,363. You would debit the creditor for $36,363, offset it with the initial deposit value of $35,714, and the gap of $649 is a credit of a foreign exchange realised gain.

- Credit = To recognise the liability has decreased.
- Realised = Because the invoice is paid.
- Gain = Reflecting the exchange rate has increased your dollar's value.

If you had paid the invoice when the initial payment was due to the supplier compared to when you actually paid it, the strengthened dollar means you're $649 better off – a realised foreign exchange gain.

If the dollar weakened, however, any resultant difference means again would have a realised foreign exchange loss.

Key takeaway: Regularly assess any advance payments made in light of current and potential exchange rates. This proactive measure ensures you're prepared for any monetary discrepancies that arise.

The Bigger Picture: Why FEX Transactions Matter

Every savvy business owner knows the importance of gross profit. If your business is involved in imports or exports, realised and unrealised foreign exchange values directly impact this figure.

When you import or export goods, the foreign exchange is effectively a part of your cost of goods sold. You're not running a bank or a hedge fund. You're running a business that manufactures or sells products. These fluctuations in currency values are genuine operating costs. They're as real as the materials you buy or the salaries you pay.

Understanding the mechanics of FEX transactions is therefore crucial for a comprehensive view of your business's financial health.

Key takeaway: Always include foreign exchange values in your gross profit calculations. It provides a clearer, more accurate picture of your financial health.

Conclusion

Foreign exchange, while intricate, doesn't need to be overwhelming. By understanding and closely monitoring the dynamics of foreign, you can more effectively navigate the dynamic waters of international currency transactions.

Staying informed and being proactive means you'll have greater financial clarity and be better equipped to make informed decisions, ultimately ensuring stability in your operations.
