**Accounting for exchange rate volatility**

The 25 per cent rupee depreciation against the dollar from a 2011 period high of 54.9785 to a 2011 period low of 43.8550 has taken most of us by surprise.

Conservative companies looked at dollar borrowings as a means to reduce the overall cost of borrowing without taking exchange rate positions.

For example, instead of taking rupee loans, they have taken dollar loans, fully hedged them to the rupee and reduced the overall cost of borrowing by 200 basis points or so.

Other companies looked at dollar borrowings as an attractive proposition because of low interest rates; hoped that the exchange rates would remain stable and did not hedge their positions to make that big kill. Unfortunately, luck proved us wrong!

EXCHANGE LOSSES

Unhedged positions result in huge foreign exchange losses on foreign currency borrowings due to rupee fall. AS-11 The Effects of Changes in Foreign Exchange Rates initially required such losses to be recognized immediately and fully in the P&L.

However, standard setters felt that if one were to take a long term view, exchange rates remained stable; and hence financial statements should be kept out of the volatility.

For example, the dollar-rupee exchange rate at the end of 2005 and 2010 was around Rs 45. Nonetheless, in between it was as low as Rs 39.47 at end of 2007 and as high as Rs 52.09 at end of March 2009.

This volatility was meaningless to a borrower that took a five year dollar term loan at the end of 2005, since he would have received and paid Rs 45 for a dollar. Accordingly AS 11 was amended on March 31, 2009 to allow capitalization/amortization of the exchange differences.

Such capitalization/amortization is not permitted under IFRS; which requires all exchange gains/losses to be recognized immediately in the P&L. Since it was intended to move to IFRS, from April 1, 2011, this option was restricted to March 31, 2011. As IFRS did not take place in 2011, the option was further extended to March 31, 2012. In a notification dated December 29, 2011, the MCA has extended the option to 2020.

This notification will also allow companies to use the capitalization/amortization policy, even if they had not used such an option earlier.

SMOOTHENING DIFFERENCES

The policy to amortize/capitalize exchange differences is not new to India. It was enshrined in Schedule VI of the Companies Act in the late 60's to tackle the then devaluation of the Indian rupee.

Some may argue that the option to defer exchange differences on long term monetary items is given with an intention to provide relief to companies who want to smoothen the impact of exchange differences on its statement of profit and loss.

Notwithstanding the intention, amortization will not result in smoothening in all cases. If exchange rates show an increasing trend then exchange difference impact of earlier years will cause a major dent in subsequent years close to repayment of those long term monetary items.

For example if a company took a loan of $100 in year 1999-2000, repayable after 3 years when exchange rate was 1$= Rs 43.

Exchange rate at end of year 1999-2000, 2000-01 and 2001-02 were Rs 43.63, Rs 46.46 and Rs 48.89 respectively.

If the company does not avail the amortization option, it will charge off exchange loss of Rs 63, Rs 283, Rs 243 in each of the year respectively. With the use of option, charge to P&L in each of the year will be Rs 21, Rs163 and Rs 406 respectively.

It is clear that use of option will lead to a significant backloading of charge of earlier years in certain scenarios.

FULL RECOGNITION

Further, whilst smoothening may be preferred by some preparers of financial statements, what is relevant to investors and analyst is a full recognition policy, as that depicts the position of the company as at a particular date, which an amortization policy distorts.

Assuming all things remain the same, a company would be preferred by an investor if it did not have a carry forward exchange loss.

Whilst there is no end to such debates, it should be kept in mind that companies that use the capitalization/amortization policy are required to make full disclosures in the financial statements. This will be useful to investors, to take appropriate calls on their investments.