Hedges
Problem 10

On August 1, 2006, Zip Ltd. purchased some merchandise from a company in Germany for DM 450,000. The liability was not due until March 1, 2007. Zip was quite confident that the exchange rate fluctuations were not a problem and took no action to hedge the liability. On November 1, 2006, Zip looked at the exchange rates and decided that they had better hedge the liability with a 120-day forward contract. Assume a December 31 year end and that all months have 30 days.

EXCHANGE RATES:

August 1 , 2006	spot rate	$ 1 = DM 2.5
November 1 , 2006	spot rate	$ 1 = DM 2.1
November 1 , 2006	120-day forward rate	$ 1 = DM 1.9
December 31, 2006	spot rate	$ 1 = DM 1.7
December 31, 2006	60-day forward rate	$ 1 = DM 2.2
March 1 , 2007	spot rate	$ 1 = DM 2.7
December 31, 2007	spot rate	$ 1 = DM 2.9
March 1 , 2008	spot rate	$ 1 = DM 2.4

Required:

(a) Prepare all the journal entries for the years 2006 and 2007 for Zip for this transaction assuming:
   (i) Fair value hedge accounting was used.
   (ii) Cash flow hedge accounting was used.

(b) Assume that the liability was an 8% note due on August 1, 2008 (instead of March 1, 2007, as given above), and that Zip does not hedge in any way. Prepare all the journal entries for the year 2006. Assume that 8% was the going rate of interest in Germany at this time for debt of this nature.