Foreign Exchange Contracts

Introduction

Under [draft] FRS 102, there will be a change in accounting for foreign exchange contracts for entities that currently do not apply FRS 26 *Financial Instruments: Recognition and Measurement.*

The example below illustrates the accounting for an entity which takes out a forward foreign exchange contract. It may do this to manage the uncertainty of cash flows associated with debtors or creditors in foreign currencies.

Current FRS (non FRS 26)

Initial recognition

Under SSAP 20 *Foreign currency translation*, a transaction in a foreign currency should initially be recognised at the exchange rate on the transaction date; or where a trading transaction is covered by a related or matching forward contract, the exchange rate specified in that contract may be used (SSAP 20.4).

Example:

A UK entity sells goods to a US customer on 1 November 201X. The invoice is for $100,000 for settlement in 3 months i.e. 31 January 201Y.

On 1 November 201X, the entity enters into a forward contract to sell $100,000 on 31 January 201Y at a contracted rate of 1.62.

The entity has a 31 December year end.

Details of GBP/USD exchange rates are below:

Date	**Spot rate**	**Forward rate to 31 January 201Y**
1 November 201X	1.6	1.62
31 December 201X	1.57	1.59
31 January 201Y	1.55	-

<u>Option 1</u>

This shows the accounting entries if the entity chooses to use the exchange rate specified in the forward contract as permitted by SSAP 20.4.

At 1 November 201X – transaction date

1.	Dr Debtors	£61,728[1]	
	Cr Sales		£61,728

At 31 December 201X – year end

No accounting entries required as SSAP 20 permits foreign currency monetary assets to be measured at the contracted rate (paragraph 6).

At 31 January 201Y – settlement date

2.	Dr Cash	£61,728	
	Cr Debtors		£61,728

<u>Option 2</u>

This shows the accounting entries if the entity uses the spot rate on the transaction date.

At 1 November 201X – transaction date

3.	Dr Debtors	£62,500[2]	
	Cr Sales		£62,500

At 31 December 201X – year end

Debtors – Re-measurement at the balance sheet date

4.	Dr Debtors	£1,194[3]	
	Cr FX gain		£1,194

At 31 January 201Y – settlement date

Debtor – re-measurement at the settlement date

5.	Dr Debtors	£822[4]	
	Cr FX gain		£822

Debtor settlement

[1] \$100,000 at the contracted rate 1.62
[2] \$100,000 at the exchange rate at transaction date 1.6
[3] \$100,000 at exchange rate at balance sheet date 1.57 (£63,694) less £62,500
[4] \$100,000 at the exchange rate at settlement date 1.55 (£64,516) less 63,694

6.	Dr Cash	£61,728[1]	
	Dr Loss on derivative	£2,788	
	Cr Debtors		£64,516

[draft] FRS 102

The debtor and the derivative are recognised separately

Foreign exchange transaction

Initial recognition - Section 30.6 requires a foreign currency transaction to be recorded at the spot rate at the transaction date.

Subsequent measurement - At the year end, foreign currency monetary items are required to be translated at the closing rate (i.e. the exchange rate at the balance sheet date, 30.20) with the difference taken through profit or loss.

Note: unlike SSAP 20, there is no option to use the forward rate at the transaction or balance sheet date. However, the only difference in the accounting for the foreign exchange transaction between current FRS and [draft] FRS 102 for an entity that currently does not apply the SSAP 20 option of using the forward rate is the recognition of the derivative under [draft] FRS 102.

Recognition of foreign exchange contract

Section 12.8 of [draft] FRS 102 requires all derivatives to be recognised at fair value with changes in fair value recognised in profit or loss.

Example:

Using the same facts as in the example above, the accounting entries for the debtor will be the same as for Option 2 (entries 3-5 above). However, there will be additional entries for recognition and measurement of the derivative:

At 1 November 201X – transaction date

At the transaction date the forward contract will have a fair value of zero.

At 31 December 201X – year end

Derivative at fair value

7.	Dr Loss on derivative	£1,165[5]	
	Cr Derivative liability		£1,165

[5] Difference between $100,000 at contracted rate 1.62 (£61,728) and forward rate at year end 1.59 (£62,893)

Derivative - fair value change at settlement date

8. Dr Loss on derivative	£1,623[6]	
Cr Derivative liability		£1,623

Debtor and derivative settlement

9. Dr Cash	£61,728[1]	
Dr Derivative liability	£2,788	
Cr Debtors		£64,516

Impact on financial statements Y/e 31 December 201X

	Current FRS (non FRS 26)		[draft] FRS 102
	Option 1	Option 2	
	£	£	£
Profit and loss			
Sales	61,728	62,500	62,500
FX gain	-	1,194	1,194
Loss on derivative	-	-	(1,165)
Total	**61,728**	**63,694**	**62,529**
Balance sheet			
Debtors	61,728	63,694	63,694
Derivative liability	**-**	**-**	(1,165)
Total	**61,728**	**63,694**	**62,529**

Impact on financial statements Y/e 31 December 201Y

	Current FRS (non FRS 26)		[draft] FRS 102
	Option 1	Option 2	
	£	£	£
Profit and loss			
Sales	-	-	-
FX gain	-	822	822
Loss on derivative	-	(2,788)	(1,623)
Total	**-**	**(1,966)**	**(801)**
Balance sheet			
Retained profit	**61,728**	**61,728**	**61,728**

[6] $100,000 at the exchange rate at settlement date 1.55 (£64,516) less 62,893

Notes:

1. Under Option 2 and [draft] FRS 102, the total impact on the P&L over the two years is the same as Option 1. The differences arise due to the timing of recognition of the loss on the derivative:
   - Option 2 - the loss is recognised on settlement
   - Option 3 – the loss is recognised in the period in which it occurs.

2. The total loss on the derivative of £2,788 represents the difference between the contracted rate and the spot rate on the date of settlement [($100,000/1.62) – ($100,000/1.55)] i.e. if the entity had not taken out the forward contract, it would have received £2,788 more cash on settlement of the debtor.

3. The net loss from currency movements is £772 (1,194 – 1,165 + 822 - 1,623), which is equal to the difference between the spot rate and the forward rate at 1 November 201X ($100,000/1.6 - $100,000/1.62). This loss is recognised at initial recognition under Option 1 and recognised as part of the sales revenue.