Financial Reporting Council

Accounting and Reporting Policy
FRS 102

Staff Education Note 11
Foreign exchange contracts

Contents

Introduction

Entities may enter into foreign exchange contracts to manage the uncertainty of cash flows associated with debtors or creditors in foreign currencies.

For entities that do not apply FRS 26 (IAS 39) *Financial instruments: Recognition and Measurement* and thereby FRS 23 (IAS 21) *The effects of changes in foreign exchange rates* and apply SSAP 20 *Foreign currency translation* to their foreign currency transactions, there will be a change of accounting treatment under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland.*

This Staff Education Note is written to highlight key areas of consideration when transitioning to FRS 102 and is not designed to be exhaustive.

Foreign currency monetary items (eg a foreign currency debtor)

Initial recognition

SSAP 20	FRS 102
A transaction in a foreign currency should initially be recognised at either: (a) the exchange rate on the transaction date; or (b) 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 paragraph 4)	Requires a foreign currency transaction to be recorded at the spot rate at the transaction date. (FRS 102 paragraph 30.7)

Subsequent measurement

SSAP 20	FRS 102
At the year end, foreign currency monetary items should be translated using the exchange rate ruling at that date, or where appropriate, the rates of exchange fixed under the terms of the relevant transactions. Where there are related or matching forward contracts in respect of trading transactions, the rates of exchange specified in those contracts may be used. (SSAP 20 paragraph 6)	At the year end, foreign currency monetary items are required to be translated at the closing rate (i.e. the exchange rate at the reporting date) with the difference taken through profit or loss. (FRS 102 paragraphs 30.9 and 30.10)

Derivatives (eg a foreign exchange contract)

Current UK accounting standards	FRS 102
Derivatives are not recognised.	Requires all derivatives to be recognised at fair value with changes in fair value recognised in profit or loss. (FRS 102 paragraph 12.8)

There is no option in FRS 102 to use the contracted forward rate at the transaction or balance sheet date. For an entity that does not currently apply the SSAP 20 option of using the forward contract rate, the only difference in the accounting for the foreign exchange transaction between current UK accounting standards and FRS 102 is the recognition of a derivative (the forward foreign exchange contract) under FRS 102.

Example

A UK entity sells goods to a US customer on 1 November 20X1. The invoice is for $100,000 for settlement in 3 months ie 31 January 20X2.

On 1 November 20X1, the entity enters into a forward contract to sell $100,000 on 31 January 20X2 at a contracted rate of £1.62:$1.

The entity has a 31 December year end.

Details of GBP to USD exchange rates are below:

Date	Spot rate (£1:$X)	Forward rate to 31 January 20X2 (£1:$X)
1 November 20X1	1.6	1.62
31 December 20X1	1.57	1.59
31 January 20X2	1.55	-

SSAP 20

Option 1: Use exchange rate specified in forward contract

This shows the accounting entries if the entity chooses to use the exchange rate specified in the forward contract as permitted by SSAP 20 paragraph 4.

At 1 November 20X1 – Transaction Date

Debtor – Recognise $100,000 at the forward rate (£1:$1.62)

Dr Debtors	£61,728
Cr Sales	£61,728

At 31 December 20X1 – Year End

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

At 31 January 20X2 – Settlement Date

Debtor – Debt is settled at the forward rate (£1:$1.62)

Dr Cash	£61,728
Cr Debtors	£61,728

Option 2: Use spot rate at transaction date

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

At 1 November 20X1 – Transaction Date

Debtor – Recognise $100,000 at the transaction date spot rate (£1: $1.6)

Dr Debtors	£62,500
Cr Sales	£62,500

At 31 December 20X1 – Year End

Debtor – Retranslate at y/e spot rate (£1:$1.57)

Dr Debtors	£1,194[1]
Cr FX gain	£1,194

At 31 January 20X2 – Settlement Date

Debtor – Retranslate at settlement date spot rate (£1: $1.55)

Dr Debtors	£822[2]
Cr FX gain	£822

Debtor – Settled at forward rate (£1:$1.62)

Dr Cash	£61,728[3]
Dr Loss on derivative	£2,788
Cr Debtors	£64,516

FRS 102

The accounting entries for the debtor will be the same as for Option 2 under SSAP 20 however there will be additional entries for recognition and measurement of the forward contract (derivative):

At 1 November 20X1 – Transaction Date

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

At 31 December 20X1 – Year End

Derivative – Recognise at fair value

Dr Loss on derivative	£1,165[4]
Cr Derivative – Liability	£1,165

At 31 January 20X2 – Settlement Date

Derivative – Fair value change at settlement date

Dr Loss on derivative	£1,623[5]
Cr Derivative liability	£1,623

Debtor and derivative settlement

Dr Cash	£61,728[6]
Dr Derivative liability	£2,788
Cr Debtors	£64,516

1 $100,000 at £1:$1.57 (£63,694) less original debtor of £62,500 equals FX gain of £1,194.

2 $100,000 at £1:$1.55 (£64,516) less y/e debtor of £63,694 equals gain of £822.

3 $100,000 at the forward rate of £1:$1.62

4 For simplicity, the loss is calculated as the difference between $100,000 at the contracted forward rate of £1:$1.62 (£61,728) and the year end forward rate £1:$1.59 (£62,893) giving a loss of £1,165.

5 For simplicity, the loss is calculated as the difference between $100,000 at the settlement date spot rate of £1:$1.55 (£64,516) and $100,000 at the y/e forward rate of £1:$1.59 (£62,893) giving a loss of £1,623.

6 $100,000 at the contracted forward rate of £1:$1.62.

Summary of impact on financial statements

For y/e 31 December 20X1

	SSAP 20		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**

For y/e 31 December 20X2

	SSAP 20		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			
Brought forward retained profit	61,728	63,694	62,529
Carried forward retained profit	**61,728**	**61,728**	**61,728**

Under SSAP 20 Option 2 and FRS 102, the total impact on profit or loss 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:

- SSAP 20 Option 2 – the loss is recognised on settlement; and
- FRS 102 – the loss is recognised in the period in which it occurs.

The total loss on the derivative of £2,788 represents the exchange difference arising on $100,000 translated at the contracted rate (£1: $1.62) and the spot rate on the date of settlement (£1:$1.55), ie if the entity had not taken out the forward contract, it would have received £2,788 more cash on settlement of the debtor.

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