HMRC - CFM26080 - SSAP 20: Hedging A Trading Transaction With A Forward Contract

This guidance applies to companies which have adopted SSAP 20 under Old UK GAAP.

Transactions covered by a matching forward contract

If a trading transaction is covered by a forward foreign exchange contract (CFM13140), so that the company knows how much in sterling terms it will pay or receive, SSAP20 (paragraph 48) permits the company to translate the transaction at the exchange rate implied in the contract. Example 1 below illustrates this.

While SSAP20 permits this treatment, it does not require it, and the company could record the purchase and the forward contract as two separate transactions. See example 2 below.

While either treatment accords with UK GAAP, the first treatment was more common in practice. Assuming that the company entered into the currency contract specifically to hedge the purchase, the first treatment better reflects the underlying economic reality - the company was never really exposed to fluctuations in exchange rates.

Note on IFRS, New UK GAAP and FRS 23 under Old UK GAAP

The first treatment is no longer permitted for companies applying IFRS, New UK GAAP or FRS 23 of Old UK GAAP, as this is considered a form of hedge accounting which does not comply with IFRS or New UK GAAP or FRS 26 of Old UK GAAP. Instead, companies are required to translate the underlying monetary item at the closing rate on the balance sheet date. Separately the forward contract is accounted for as a derivative at fair value.

Different accounting might arise if a forward contract is designated part of a hedging relationship under IFRS or New UK GAAP or FRS 26 of Old UK GAAP.

Example 1

Tennspo Ltd buys goods from a Norwegian supplier on 2 January 20X5 for Norwegian krone (NOK) 1 million. The NOK 1 million is payable on 31 March 20X5. At 2 January, the exchange rate is NOK 12.50/£.

On 2 January, the company enters into a forward contract to buy NOK 1 million, for delivery on 31 March, at a forward rate of NOK 12.80/£. It therefore knows that, whatever the spot rate on 31 March, it is going to have to pay £78,125 to settle the liability.

Under SSAP 20, the most usual accounting treatment would be for the company to record the purchase at a rate of NOK 12.80/£, i.e. to show the goods as purchased for £78,125. Thus no exchange differences are recorded, either on the purchase or on the forward contract used to hedge it. Such treatment is not permitted for companies adopting IFRS, New UK GAAP or FRS 23 of Old UK GAAP.

Example 2

The facts are as in example 1, except that the company accounts for the purchase and the forward currency contract separately. The exchange rate at 31 March is NOK 13.00/£.

The NOK 1 million debt that the company incurs on 2 January is recorded at £80,000 on that date, with a matching entry to stock. As at 31 March, the debt is re-translated to £76,923 using the closing rate at that date. An exchange gain of £3,077 therefore arises.

Under the forward contract, the company has contracted to buy NOK 1 million for £78,125 on 31 March, but at that date the currency is only worth £76,923 at spot rates. A loss of £1,202 therefore arises on the forward contract. There is more about accounting for forward contracts at CFM26100.

On 31 March, the company settles the forward contract with a net payment to the counterparty of £1,202 (as it is out-of-the-money), and pays the supplier £76,923. Therefore, the overall cash cost to the company is £78,125, which is the same as the cost of raw materials recognised at example 1.

However, instead of simply recording the raw materials at a cost of £78,125, the company recognises an exchange gain of £3,077, and a loss on the forward contract of £1,202, while recording the purchase of the raw material at £80,000. You will note that once the stock is expensed to profit and loss account, the overall net effect, an expense of £78,125, will be the same as example 1.

Note on IFRS, New UK GAAP and FRS 23 under Old UK GAAP

The accounting required under IFRS, New GAAP and FRS 23 of Old UK GAAP would be similar to that in this example, except that any gains or losses on the forward contract would be recognised at each balance sheet date, and not just on settlement. Different rules potentially apply to forward contracts designated as part of a cash-flow hedge under IFRS, New UK GAAP or FRS 26 of Old UK GAAP.

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