IFRS®
Accounting Standards

Hot topics for treasury centres

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Preface

We are delighted to present to you our publication on IFRS® Accounting Standards - hot topics for treasury centres. This publication aims to provide valuable insights and guidance on various aspects of treasury centres' operations, including functional currency determination, foreign currency translation rules, foreign currency risk management, cash and liquidity risk management including trade finance, interest rate risk management, and some tax considerations.

Multinational corporate treasury departments are often organised in a centralised way, adding complexity to the accounting for some of the frequent internal and external transactions. It is therefore essential for treasury professionals to stay up-to-date with the latest accounting standards and regulatory requirements to ensure compliance and to drive strategic decision-making.

Each section provides an overview of the topic, highlights key accounting principles and best practices and provides practical examples.

In the first section of this publication, we delve into the importance of determining the functional currency for treasury centres. We discuss the factors that influence this determination and provide illustrative examples to help you better understand the concept.

The next section focuses on translation rules, covering the translation of foreign transactions into the functional currency and the subsequent translation to the presentation currency. We also address the application of these rules to treasury centres and highlight considerations related to intercompany balances.

Foreign currency risk management is a critical aspect of treasury centres' operations, and we dedicate a section to discuss hedging group FX risks through a treasury centre. We address frequently asked questions and provide illustrative examples to enhance your understanding of this topic.

Another key area we cover is cash, liquidity and interest rate risk management. We explore various aspects including cash and cash equivalents definitions, offsetting and cash pooling arrangements, and their application to cash management arrangements. We also touch upon interest rate risk hedges, trade finance and working capital optimisation.

Tax considerations are an integral part of treasury centres' operations, and we provide valuable insights into this area.

Whether you are a treasury centre professional or a finance executive, we believe this publication will serve as a valuable resource to enhance your understanding of accounting topics specific to treasury centres. We made it comprehensive so you can use it as a guide. To do so we incorporated both extracts from and links to our digital platform "Viewpoint" that provides accounting standard, financial reporting, business and regulatory hot topics insights. If you would like to know more about certain topics, you are welcome to subscribe to it.

(https://viewpoint.pwc.com).

We hope you find this publication informative and insightful. Should you have any questions or require further assistance, please do not hesitate to reach out to our team of experts.

Thank you for choosing our publication, and we hope you find it informative and beneficial in your treasury centre operations.

Best regards,

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A. Foreign currency considerations

1. Determination of the functional currency

1.1 Why is a treasury centre's functional currency important?

An entity's functional currency is the currency of the primary economic environment in which the entity operates. The primary economic environment is normally the economic environment in which the entity primarily generates and expends cash (MoA 49.8).

The majority of a treasury centre's assets and liabilities are typically monetary items. This means that, where assets and liabilities are denominated in a currency other than the treasury centre's functional currency, they need to be translated to this functional currency at the spot FX rate at each balance sheet date. Exchange rate movements therefore directly impact the treasury centre's profit or loss, and the determination of functional currency can significantly impact its reported results.

If the functional currency is determined incorrectly, almost everything in the treasury centre's financial statements is likely to be affected. The functional currency determination will also impact the treasury centre's risk management activities and the hedging strategies adopted.

1.2 How is functional currency determined?

IAS 21 requires each individual entity to determine its functional currency and measure its results and financial position in that currency. In consolidated accounts, the functional currency is determined at the level of each entity within a group. It follows that different entities within a group could have different functional currencies. However, there is no such thing as a group functional currency (MoA 49.5).

The functional currency serves as the basis for determining whether the entity is engaging in foreign currency transactions. IAS 21 defines foreign currency as a currency other than the functional currency. Identifying the functional currency has a direct impact on which transactions are foreign currency transactions that give rise to exchange gains and losses and, thereby, on the reported results (MoA 49.6).

An entity's functional currency is the currency of the primary economic environment in which the entity operates. The primary economic environment is normally the economic environment in which the entity primarily generates and expends cash. The functional currency is normally the currency of the country in which the entity is located. It might, however, be a different currency (MoA 49.8).

IAS 21 requires entities to consider primary and secondary indicators in order to determine functional currency. Primary indicators are closely linked to the primary economic environment in which the entity operates, and they are given more weight. Secondary indicators provide supporting evidence to determine an entity's functional currency. Determining an entity's functional currency depends on the facts and circumstances (MoA 49.9).

1.2.1 Primary indicators

IAS 21.9 explains that the primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. As a result, an entity considers the following factors in determining its functional currency:

a. the currency:

   i. that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

   ii. of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

b. the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled) (IAS 21.9)

1.2.2 Secondary indicators

IAS 21.10 sets out as secondary indicators of an entity's functional currency:

a. the currency in which funds from financing activities (that is, issuing debt and equity instruments) are generated,

b. the currency in which receipts from operating activities are usually retained (IAS 21.10).

1.2.3 Foreign operation indicators

IAS 21.11 also contains guidance for determining an entity's functional currency where the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. If this is the case the entity will often follow its parent's functional currency.

1.3 Application to treasury centres

After considering all of the relevant indicators, the functional currency of a treasury centre might still not be obvious. The treasury operation might be diverse, with cash flows, financing and transactions occurring in more than one currency. In these situations, judgement is required in determining the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. When the above indicators are mixed and the functional currency is not obvious, management uses its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. In exercising that judgement, management should give priority to the primary indicators before considering secondary indicators and additional factors (IAS 21.12).

Nevertheless, in many instances the indicators in IAS 21.11 will prove to be the key indicators in determining the functional currency of treasury centres (and shared service centres).

IAS 21.11 Indicators	Conditions pointing to functional currency being different from that of the reporting entity	Conditions pointing to functional currency being the same as that of the reporting entity
Degree of autonomy	The treasury centre has independent management and activities are carried out with a significant degree of autonomy. This will often be the case for a strategic treasury that actively contributes to the strategic decisions of the whole business and provides financial leadership. Such a treasury centre may be a profit centre rather than a cost centre.	The treasury centre has little management discretion as its activities are carried out as an extension of the reporting entity. This will often be the case for a transactional treasury, which plays a focused execution role enabling the business to carry out necessary transactions. Such a treasury centre is likely to be a cost centre for the business.
Frequency of transactions with reporting entity	Few inter-company transactions with the reporting entity.	Frequent and extensive inter-company transactions with the reporting entity.
Foreign operation's cash flows impact on reporting entity	Do not directly affect the reporting entity's cash flows.	Directly affect the reporting entity's cash flows and are readily available for remittance to the reporting entity.
Servicing debt obligations	Cash flows from the treasury operations are primarily in a currency other than that of the reporting entity and sufficient to service existing and normally expected debt obligations.	Significant financing from, or reliance on, the reporting entity to service existing and normally expected debt obligations.

(MoA 49.11)

1.4 Illustrative examples

1.4.1 Functional currency of an entity investing in assets in a currency different from the functional currency of other entities in the group

Background

A French-listed parent has significant French, UK and US operating subsidiaries, but no Japanese operations. The French parent creates a new subsidiary, Newco SA, incorporated and resident in France. Newco issues equity capital of yen 1 billion to the French parent, receiving yen 1 billion of cash. Newco also raises yen 100 million of external financing and places the yen 1.1 billion total cash on deposit with a bank in Japan, earning 0.1% interest per annum. The cash will be reinvested in yen-denominated financial instruments, such as bonds and commercial paper. Newco has few members of staff who manage the entity's investing activities. It incurs euro operational costs that are insignificant compared to the interest paid on its yen borrowing. Like any wholly owned subsidiary, the retained profits are under the parent's control. Newco does not undertake any key operating activities on its own.

Analysis

Consideration of the currency that mainly influences sales and costs is not directly relevant. Newco incurs expenses in euros, but these are not significant enough to suggest that the euro is the functional currency. It is necessary to look at the secondary indicators. Newco raises finance by issuing its own equity instruments to the parent in a currency that is different from the parent, but the proceeds are invested in yen-denominated assets at the behest of the parent. The external funds raised through the issue of debt instruments are insignificant compared to the issue of equity shares to the parent. The decision to reinvest or distribute income earned from the yen-denominated assets is under the parent's control.

Consideration of the other additional factors suggests that Newco is a 'cash box' type entity, with no independent management/activity. Newco is simply a conduit for the parent entity that could have invested in the yen assets directly. The 'autonomy' indicator points to the euro as the functional currency because Newco appears to be merely an extension of the activities of the parent. This would point to the functional currency being the same as that of its parent − the euro. (EX 49.11.10).

1.4.2 Functional currency of separate treasury centres in different geographical areas

Background

A Swiss multi-national entity, with the Swiss franc as its functional currency, has operating subsidiaries in the US and Europe whose functional currencies are US dollars and euros respectively. It has established a treasury centre in each of these geographical regions. The activities of the two treasury centres are identical, in that each provides financial and risk management services to its relevant operating subsidiaries. All transactions (for example, management of liquid funds, borrowings and hedging activities) between a treasury centre and its respective operating subsidiaries are carried out in either US dollars or euros.

Each treasury centre earns dividends and income from cash management activities in US dollars and euros respectively. Each treasury centre charges a monthly fee for providing such financial services to its operating subsidiaries that is denominated in either US dollars or euros, depending on its area of operation. All operating costs − such as staff costs payable to treasury and financial management specialists and other administrative and running costs − are incurred and settled by each treasury centre in US dollars or euros. The treasury centres' short- and long-term financing are provided by the Swiss parent in the form of Swiss franc loans. The treasury centres do not retain any US dollars or euros generated from their operation for their own use. After meeting local expenses, management either uses US dollars or euros to settle the inter-entity payables to the operating subsidiaries, or it distributes any surplus to the parent as dividends.

Analysis

This illustration addresses only the US dollar treasury centre; however, the considerations for the euro treasury centre are the same.

The primary factors (currency that influences sales price and the costs of providing goods and services) are arguably irrelevant, because the treasury centre does not have any third-party sales and purchases. However, the determination of the functional currency is an entity-by-entity question, and it is not relevant to whether an entity's fee income comes from inside or outside the group. What is relevant is the nature of the fee income and the manner in which it is earned.

In this example, the treasury centre provides financial services to the US operating subsidiaries for which it charges a fee. The fees are invoiced and settled in US dollars. The treasury centre also earns investment income in US dollars. Because the treasury centre earns its revenue and income in US dollars, and the underlying US economy determines the pricing of the treasury centre's fee income to the US operating subsidiaries, the 'sales and cash inflows' indicator identifies US dollars as the functional currency of the treasury centre. Since all administrative and local expenses are incurred and settled in US dollars, the 'expenses and cash outflows' indicator also provides evidence that US dollars is the treasury centre's functional currency.

The primary economic environment in which the treasury centre generates and expends cash is the US and, therefore, its functional currency is US dollars. The primary indicators are clear, so there is no need to consider the secondary indicators, even if these seem to provide evidence that the Swiss franc is the functional currency (for example, the treasury centre's short- and long-term financing is primarily in the form of Swiss franc loans from the parent). (EX 49.11.11)

1.4.3 Functional currency of a treasury centre that pools resources in the group

Background

A UK multi-national entity, with sterling as its functional currency, has set up a treasury centre in Switzerland. The treasury centre borrows US dollars, euros and sterling in the euro-market, and lends the proceeds to its parent and other operating subsidiaries, with the loans denominated in the borrowing entity's functional currency. As part of its cash management operations, it pools the liquid resources of the parent and the operational units and invests them temporarily in the euro-market. It also manages foreign exchange and interest rate risks of operating units by executing derivative contracts with third parties and/or with operating units.

The treasury centre earns dividends and income from cash management activities in US dollars, euros and sterling. It charges a monthly fee for providing such financial services to its parent and operating subsidiaries that is denominated in the relevant entity's functional currencies. All operating costs, such as staff costs payable to treasury and financial management specialists and other administrative and running costs, are incurred and settled in Swiss francs. The treasury centre's short- and long-term financing needs are provided by its parent in the form of sterling loans.

The treasury centre provides financial services to group companies for which it charges a fee. However, the fees are invoiced in the functional currencies of the group companies and settled in those currencies. This ensures that the risk of non-functional currency transaction gains and losses on all inter-company transactions with the treasury centre are passed on from the operating units to the treasury centre for centralised management and control.

The treasury centre also earns investment income in US dollars, euros and sterling.

Analysis

Because the treasury centre earns its revenue and income in different currencies, the 'sales and cash inflows' indicator fails to identify a particular currency that is significant, in its own right, as the functional currency of the treasury centre. Furthermore, there is no explicit or implicit evidence to suggest that the underlying Swiss economy determines the pricing of the treasury centre's fee income to the group companies.

On the other hand, all administrative and local expenses are incurred and settled in Swiss francs, so the 'expenses and cash outflows' indicator provides evidence that the Swiss franc is the functional currency. However, because the primary indicators are not sufficiently conclusive in identifying the functional currency, it is necessary to consider the secondary indicators.

The secondary indicators provide evidence that sterling is the functional currency. This is because the treasury centre does not raise any finance from external local sources, for meeting the cost of its operations in excess of its operating income but relies on short- and long-term financing from its parent. Furthermore, the cash inflows from operations occur in various currencies and are used to meet local expenses, so the 'retention of cash' indicator is not significant in determining the treasury centre's functional currency.

The additional factors also support sterling as the functional currency. For example, the 'autonomy' indicator suggests that the UK parent has set up the treasury centre to achieve overall financial efficiency of its international operations through centralised control and effective management of cash and financial risk. The volume of inter-company transactions is large, due to the regular transfer of foreign currency cash balances from and to the parent. The treasury centre's cash flows, therefore, impact the parent's cash flows on a regular basis. The 'financing' indicator also identifies sterling as the functional currency.

pThis analysis suggests that the primary indicators do not provide conclusive evidence that Swiss francs (the currency of the country in which the treasury centre operates) is its functional currency. However, the secondary indicators support sterling as the functional currency. Overall, the evidence is mixed. Management should exercise judgement in determining the currency that most faithfully represents the economic effects of the treasury centre's activities. There are a number of possible solutions. One indicator might be that the treasury centre has been set up primarily as a conduit to undertake

the treasury operations of the entire multinational group headed by the UK parent. The currency of the country that most faithfully represents the treasury centre's operations is, therefore, the functional currency of the UK parent: sterling. Another factor to consider is whether any of the three major currencies (dollars, euros, sterling) is dominant. If no clear currency is suggested by the previous factors, and if the treasury centre's operating expenses are significant, the Swiss franc might be the treasury centre's functional currency. (EX 49.11.12).

1.5 Functional currency of a division

An entity might have multiple foreign operations. A foreign operation is an entity that is a subsidiary, associate, branch or joint arrangement whose activities are based or conducted in a country or currency other than that of the reporting entity. A legal entity might have more than one distinct and separable foreign operation, such as a division or a branch (MoA 49.12).

For example, a legal treasury entity might have treasury centres operating as branches in the UK and Singapore. In this case each branch should determine its functional currency and measure its results and financial position in that currency before they can be included in the reporting entity when it prepares its financial statements.

PwC insight

Assessing whether an operation within a single legal entity (such as a division or branch) is a separate entity for the purposes of IAS 21 is not specifically addressed in IAS 21 and is highly judgmental. We believe that, in determining whether an operation could be considered a separate entity for the purposes of IAS 21 and therefore have its own functional currency, the definition of a 'business' under IFRS 3 could be useful (FAQ 49.12.1).

A business is defined as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities (IFRS 3 App A).

The three components of a business are: inputs; processes; and outputs.(IFRS 3 App B para B7).

An input is an economic resource that creates outputs, or has the ability to contribute to the creation of outputs when one or more processes are applied to it. Examples are:

- Non-current assets (including intangible assets or rights to use non-current assets).
- Intellectual property.
- The ability to access necessary materials or rights.
- Employees.

(IFRS 3 App B para B7(a)).

A process is a system, standard, protocol, convention or rule that, when it is applied to an input or inputs creates outputs, or has the ability to contribute to the creation of outputs. Examples are:

- Strategic management processes.
- Operational processes.
- Resource management processes.

Processes are usually documented. The intellectual capacity of an organised workforce that has the skill and experience to follow conventions might provide the processes that, when applied to inputs, can create outputs. (IFRS 3 App B para B7(b)).

Inputs and processes that are not used to create outputs are generally not considered significant to the determination of whether the acquired group is a business. For example, whether the acquired group includes or excludes certain administrative or support processes, such as accounting, payroll and other administrative systems, generally will not impact the determination of whether a business exists. (IFRS 3 App B para B7(b)).

Outputs are the result of inputs and processes applied to those inputs that provide goods or services to customers, generate investment income (such as interest or dividends) or generate other income from ordinary activities. (IFRS 3 App B para B7(c)).

A business consists of inputs and processes applied to the inputs that have the ability to contribute to the creation of outputs. (IFRS 3 App B para B7).

Although businesses usually have outputs, outputs are not required for an integrated set of activities and assets to qualify as a business. Not all inputs and associated processes used by the seller need to be transferred to be considered a business. However, an integrated set of activities and assets must include an input and a substantive process that significantly contribute to the ability to create outputs. (IFRS 3 App B para B8).

2. Change in functional currency

It is important to note that a treasury centre's functional currency might not remain constant over time, and so it should be reassessed periodically, particularly when its location, activities or function changes. Such a change might be triggered by a change in the location of the treasury centre from one jurisdiction to another. However, it can also change as a result of a change in the role of treasury in the organisation, for example from a transactional treasury into a strategic treasury partnering with the business. Changes in how treasury is financed or indeed a change in the predominant activities of the business itself can also result in changes to the treasury centre's functional currency.

Any change in a treasury centre's functional currency should be accounted for prospectively from the date of change. It might not be practicable to determine the date of change at a precise point during the reporting period. It is also possible that the change could have occurred gradually during the reporting period. If so, it might be acceptable to account for the change as of the beginning or end of the accounting period in which the change occurs, whichever more closely approximates to the date of change (FAQ 49.18.5).

Management should translate all items into the new functional currency using the exchange rate at the date of change. Because the change was brought about by changed circumstances, it does not represent a change in accounting policy and, so a retrospective adjustment under IAS 8 is not appropriate. Since all assets and liabilities are translated using the exchange rate at the date of change, the resulting translated amounts for non-monetary items are treated as their historical cost. Exchange differences arising from the translation of a foreign operation previously recognised in other comprehensive income are not reclassified from equity to profit or loss until the disposal of the operation (MoA 49.17).

Changing a treasury centre's functional currency can have a significant effect on its foreign currency risk management strategy, which is addressed in section 4 of this publication.

3. Translation rules

3.1 Translating foreign transactions into the functional currency

A foreign currency transaction is recorded, on initial recognition, at the spot exchange rate between the functional currency and the foreign currency at the date of the transaction (MoA 49.20).

Subsequently, translation rules differ depending on whether the foreign currency items are monetary or non-monetary items and their measurement basis:

Type of item	Measurement	Rate
Monetary		Closing spot rate.
Non-monetary	Cost	Exchange rate at the date of the transaction.
Non-monetary	Fair value	Exchange rate at the date when the fair value was determined.

(MoA 49.27), (MoA 49.29), (MoA 49.30)

Monetary items are units of currency held, and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. The essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency (MoA 49.26).

Non-monetary items are all items other than monetary items (MoA 49.28).

As a general rule, exchange differences arising on the settlement of monetary items, or on translating monetary items at rates different from those at which they were translated on initial recognition, are recognised in profit or loss in the period in which they arise (MoA 49.31).

Nevertheless, there are exceptions to the general rule, including the following:

- A monetary item that is designated as a hedging instrument in a cash flow hedge. Any exchange difference that forms part of the gain or loss on the hedging instrument, to the extent that the hedge is effective, is recognised initially in other comprehensive income;
- A monetary item that is designated as a hedge of a net investment in consolidated financial statements. The exchange difference on the hedging instrument, to the extent that the hedge is effective, is recognised in other comprehensive income;
- A monetary item that forms part of the net investment in a foreign operation in the consolidated financial statements (MoA 49.35). In the financial statements that include the foreign operation and the reporting entity (for example, consolidated financial statements where the foreign operation is a subsidiary), such exchange differences are recognised initially in other comprehensive income, and they are reclassified from equity to profit or loss on disposal of the net investment (MoA 49.56).

Note that monetary assets classified as fair value through other comprehensive income in accordance with IFRS 9 are carried at fair value. However, for the purpose of calculating foreign exchange differences to be recognised in profit or loss, they are treated as if they were carried at amortised cost. The exchange differences attributable to the amortised cost of such monetary assets are recognised in the income statement. Exchange differences attributable to the residual amount of the monetary assets' fair value are recognised in other comprehensive income along with other fair value gains and losses (MoA 49.34).

An illustrative example is provided in Example 14 in the Illustrative examples and implementation guidance section of IFRS 9.

Where a gain or loss on a non-monetary item is recognised directly in other comprehensive income, for example revaluation gains of an own-use property in a different country with a currency other than the entity's functional currency, any exchange component of that gain or loss is recognised directly in other comprehensive income (MoA 49.36).

Where a gain or loss on a non-monetary item is recognised in profit or loss, for example the impairment of a brand where related cash flows are earned in a foreign currency, any exchange component is also recognised in profit or loss (MoA 49.37).

3.2 Lack of exchangeability

In countries where there are restrictions on the availability of currency and a practice of using a rate other than the official one, the treasurer may historically have managed the exposure to foreign currency with that rate. This is often the case in countries with hyper-inflationary indicators. However, for financial reporting purposes the accounting team was usually required to use the official rate.

When a currency is not exchangeable into another currency, the spot exchange rate needs to be estimated. IAS 21 has recently been amended to provide additional guidance on when a currency is exchangeable and, if it is not, how to estimate the spot exchange rate for reporting purposes. In certain circumstances this will mean using an estimation technique that may be based on the unofficial rate.

As a strategic adviser, treasurers will need to support the accountants on the level of exchangeability and what an appropriate rate may be. This amendment to the standard may also bring accounting and risk management closer together.

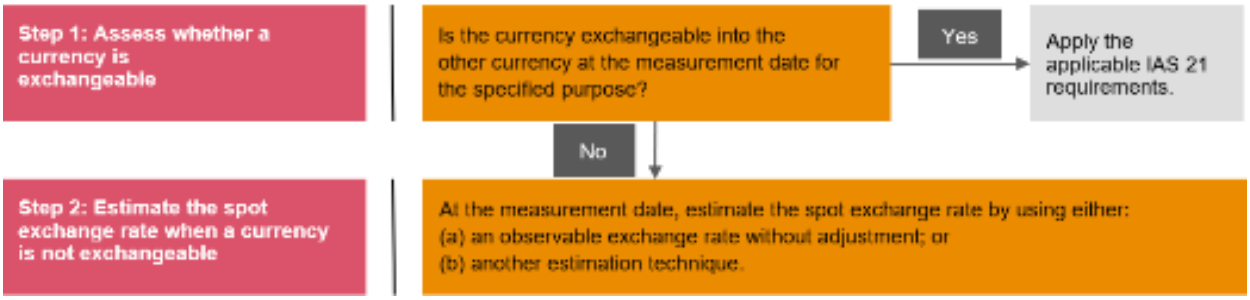
In August 2023, the International Accounting Standards Board (IASB) made amendments to IAS 21 to address the issue of determining exchangeability between currencies and the spot exchange rate to use when exchangeability is lacking. These amendments will be effective for annual reporting periods starting on or after 1 January 2025, with early application permitted, and will be relevant to entities that have transactions or operations in a foreign currency that is not exchangeable into another currency at a measurement date for a specified purpose.

Previously, IAS 21 provided guidance on the exchange rate to use when exchangeability between two currencies is temporarily lacking, but not when lack of exchangeability is not temporary.

A currency is exchangeable when an entity is able to obtain the other currency within a time frame that allows for a normal administrative delay and through a market or exchange mechanism in which an exchange transaction would create enforceable rights and obligations.

When a currency is not exchangeable into another currency, the spot exchange rate needs to be estimated. The objective in estimating the spot exchange rate at a measurement date is to determine the rate at which an orderly exchange transaction would take place at that date between market participants under prevailing economic conditions.

The following diagram was added to IAS 21 to help entities to assess the requirements:



The amendments also brings in additional disclosure requirements to enable users of an entity's financial statements to understand how the currency not being exchangeable into the other currency affects, or is expected to affect, the entity's financial performance, financial position and cash flows. (MoA 49.80-92)

3.3 Translating functional currency to presentation currency

IAS 21 allows an entity to present its financial statements in any currency of its choosing. Where a group contains individual entities with different functional currencies, the results and financial position of each entity are translated into a common presentation currency.

IAS 21 prescribes a methodology for translating from the functional currency to a different presentation currency. This translation methodology seeks to ensure that the financial and operational relationships between underlying amounts established in the entity's primary economic environment and measured in its functional currency are preserved when translated into a different presentation currency.

The translation methodology requires the results and financial position of an entity (whose functional currency is not the currency of a hyper-inflationary economy) to be translated into a different presentation currency using the following procedures:

- Assets and liabilities for each balance sheet presented (including comparatives) are translated at the closing rate at the balance sheet date.
- Income and expenses for each statement presenting profit or loss and other comprehensive income (including comparatives) are translated at exchange rates at the transaction dates. For practical reasons, a rate that approximates to the exchange rates at the transaction dates - for example, an average rate for the relevant period − is often used.
- All resulting exchange differences are recognised in other comprehensive income, and they are accumulated as a separate component of equity. This separate component of equity is often referred to as cumulative translation adjustment (CTA) (MoA 49.42).

The exchange differences referred to in the last bullet point above comprise:

- Differences arising from translating the income statement at exchange rates at the transaction dates or at average rates, and assets and liabilities at the closing rate. Such exchange differences arise on items recognised in the income statement as well as in other comprehensive income; and
- Differences arising on the opening net assets' re-translation at a closing rate that differs from the previous closing rate (MoA 49.43).

Once the foreign operation's financial statements have been translated into the reporting entity's presentation currency, their incorporation into the reporting entity's consolidated financial statements follows normal consolidation procedures (MoA 49.45).

The standard is silent on how to translate equity items, including those that:

- are recognised directly in equity (that is, items that have not been recognised through the performance statements, such as share capital, share premium or treasury shares);
- arise from income and expenses recognised in profit or loss and other comprehensive income (such as remeasurements of defined benefit pension plans, if applicable) – that is, retained earnings; and
- arise from income and expenses recognised in other comprehensive income, other than the CTA itself (for example, IAS 16 or IAS 38 revaluation reserves, and IFRS 9 fair value or hedging reserves).

As a result, we believe that an entity has a choice of using either the historical rate or the closing rate for these items. The chosen policy has no impact on the amount of total equity, but it should be applied consistently to similar items (for example, each category of items listed in each bullet point above). We therefore believe that it would be acceptable, for example, to retranslate all reserves arising from income and expenses recognised in other comprehensive income, while retaining all other reserves at historical rates. However, the regulatory framework in some jurisdictions might require a specific treatment for some reserves (MoA 49.46).

If the closing rate is used, the exchange differences that result from re-translating equity items are recognised directly in equity. We believe that it is acceptable to recognise such exchange differences as part of either the CTA reserve (directly or via a transfer within equity) or another equity reserve. If the difference is recognised as part of the CTA reserve, this effectively reduces the CTA that arises on re-translating the net assets. Any exchange differences arising on re-translating equity items are recognised directly in equity, with the result that the CTA movement in equity will not equal the CTA recognised in total comprehensive income (FAQ 49.46.1).

3.4 Application of translation rules to a treasury centre

Where the treasury centre has the same functional currency as its parent, translating treasury centre financials to the presentation currency of the parent does not pose any specific challenge. However, the accounting outcome becomes less obvious when a treasury centre and its parent have different functional currencies.

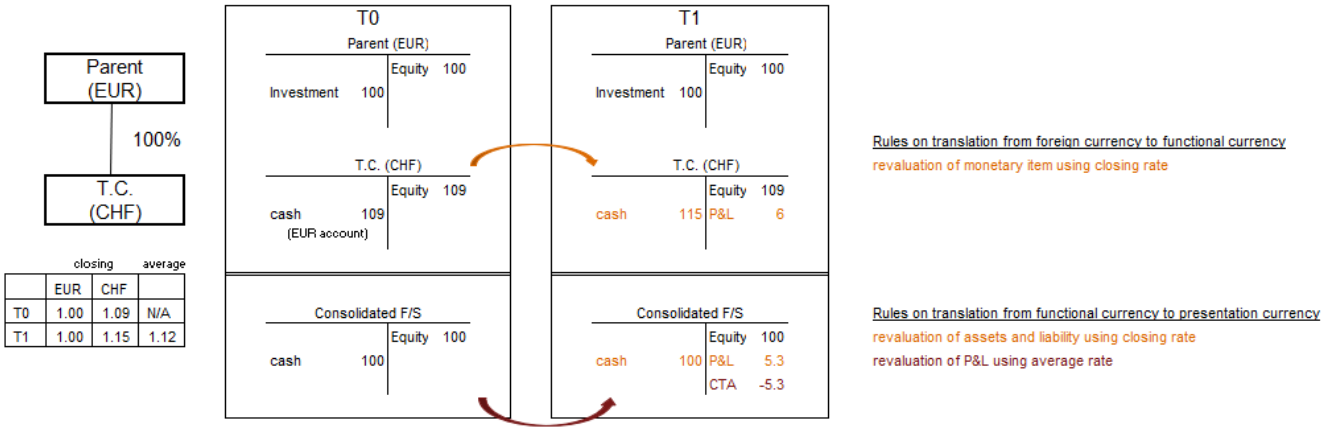
The following example illustrates some translation challenges arising when a treasury centre and its parent have a different functional currency.

Assume the following:

A EUR functional currency parent entity owns 100% of a CFH functional currency subsidiary.

The only asset of the parent is the investment in the subsidiary and the only asset of the subsidiary consists of a EUR bank account.

The illustration below represents individual positions in the respective currencies and the effect of the translation on the subsidiary stand alone accounts (from foreign currency asset to functional currency asset) and the effect of translation from the functional to the presentation currency at both inception (T0) and subsequent closing period (T1).



At T1, the following is performed:

- the monetary asset is translated at the spot rate of 1.15 to go from the foreign currency to the functional currency; and
- the investment in subsidiary is eliminated against equity, and the average rate of 1.12 is used to translate the P&L of the year, generating a CTA equal to the translated P&L effect of 5.3)

Therefore, overall, the application of the retranslation rules in IAS 21 to a EUR bank account held by a CHF functional treasury centre results in a gain or loss recognised in consolidated profit or loss and an offsetting CTA adjustment through other comprehensive income on translation to the group's EUR functional and presentation currency.

3.5 Other considerations – intercompany balances

Where the treasury centre is the primary entity within a group that engages with financial markets, it may have many of its external derivative and cash positions offset by intercompany instruments. For example, the treasury centre might place orders on behalf of the business such that all external derivatives and loans are matched with offsetting internal positions in the same currencies. If this is the case, the treasury centre's own FX exposure might not be significant.

However, to the extent that intercompany derivatives are not used to offset the treasury centre's external derivative positions, or the treasury centre has a mismatch between the currency of external funding and internal lending, the treasury centre could be exposed to significant variability in profit or loss from changes in exchange rates.

Even where the internal counterparty has an offsetting position of its own, the decision whether or not to use an inter-company derivative (or foreign currency cash instrument) can still impact the overall group's profit or loss due to the use of average rates to translate foreign operations to the reporting entity's presentational currency, as allowed by IAS 21.40 (to the extent that exchange rates do not fluctuate significantly).

Furthermore, intercompany balances between the treasury centre and business units involving foreign currencies may also impact consolidated profit or loss. These can arise, for example, from financing provided by the treasury centre or physical cash pools. IAS 21 requires both counterparties to translate such monetary balances to their own functional currency, with exchange differences being recognised in profit or loss. Despite these balances being intra-group transactions, which are eliminated from the balance sheet on consolidation, the FX gains and losses recognised at each entity level remain in consolidated profit or loss and may have implications for tax or liquidity (FAQ 49.52.1).

4. Foreign currency risk management

4.1 Hedging group FX risks through a treasury centre

4.1.1 General overview

Entities are exposed to financial risks arising from many aspects of their business. Typically, treasury centres will be concerned about exchange rates and interest rates, while some might also be concerned about commodity prices. Various risk management strategies are implemented to eliminate, reduce or modify risk exposures.

There are several ways for the treasury centre to manage and hedge (Group) positions. Entities with sophisticated central treasury functions often use internal hedging transactions to 'transfer' interest rate and currency risk to the group treasury. For such entities, central treasury will often enter into internal derivative contracts (such as forward contracts and swaps) with subsidiaries and divisions of a consolidated group that meet the risk management needs of those business units. Central treasury will assess its overall net exposure to different currencies and to interest rate risk, and it will enter into external forward contracts and swaps to manage those risks on a centralised basis, thereby generating economies of scale and pricing efficiency. For example, the treasury centre might seek to hedge only the group's net currency position rather than hedging every gross position held by the group.

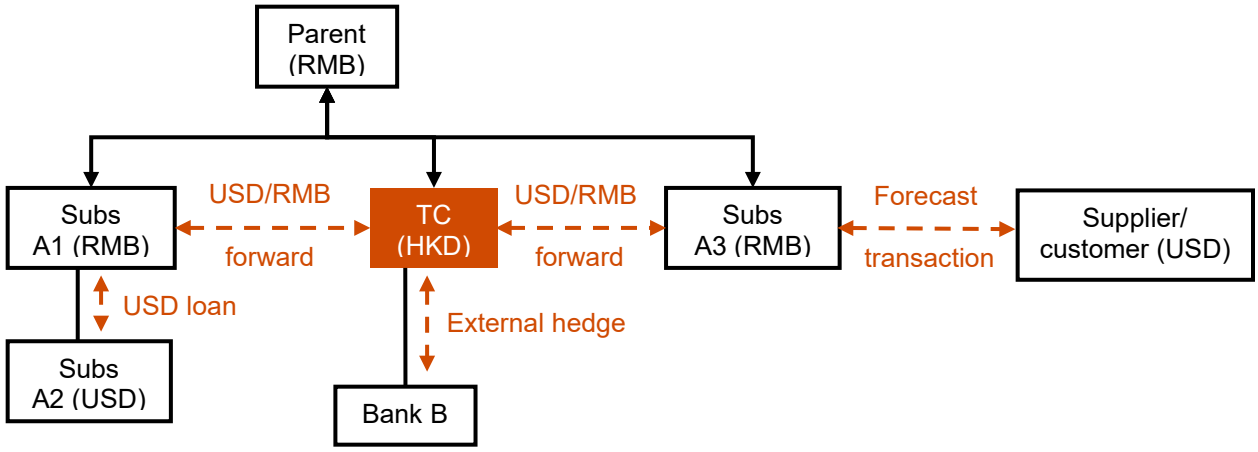
When hedging is executed using such a centralised structure, the accounting for foreign currency transactions in the individual and the consolidated financial statements can be complex, particularly when the entity or the group wishes to apply hedge accounting in its consolidated financial statements.

PwC insight

Hedge accounting is optional, and management should consider the costs and benefits when deciding whether to use it (FAQ 46.1.1). The objective of hedge accounting is to faithfully represent the effect of risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (P&L) or other comprehensive income (OCI) (MoA 46.1).

In simple terms, hedge accounting is a technique that modifies the normal basis for recognising gains and losses (or income and expenses) on associated hedging instruments and hedged items, so that both are recognised in P&L (or OCI) in the same accounting period. This is a matching concept that eliminates, or reduces, the volatility in the statement of comprehensive income that otherwise would arise if the hedged item and the hedging instrument were accounted for separately under IFRS Accounting Standards (FAQ 46.1.1). IFRS Accounting Standards allow three different hedge accounting models: cash flow hedges, fair value hedges and net investment hedges.

An example of how hedging activities might be structured through a treasury centre ('TC') is illustrated below:



All of the group's external treasury activities are undertaken by TC. Individual subsidiaries wishing to hedge their exposure to foreign currency risk are required to enter into internal derivative contracts with TC, which in turn enters into an external derivative contract with a third party Bank B.

From an economic standpoint, Subsidiaries A1 and A3 enter into an internal forward to transfer their FX risk to TC in order to close the FX open position arising in their separate financial statements.

TC enters into external derivatives to mitigate some or all of its net risk/exposure. For example, TC might hedge only spot FX risk, and retain an exposure for duration mismatches between the internal derivatives with Subsidiaries A1 and A3, or alternatively mitigate all risk – that is, both spot FX and forward points.

PwC insight

An entity with many foreign operations may be exposed to a number of foreign currency risks. There are two distinct financial reporting concepts arising from translating foreign currencies that are sometimes confused in practice. It is important to distinguish between the two because the differences in the risk exposures will require different type of hedges:

1. Foreign exchange differences arising from translating monetary items denominated in a foreign currency are recognised in profit or loss in the period in which they arise. Such transactional FX risk can be hedged either:
    a. in a hedge of the change in fair value of a recognised asset or liability - such as a foreign currency borrowing - or an unrecognised firm commitment in a fair value hedge; or
    b. in a hedge of the exposure to variability in forecast cash flow, such as foreign currency interest and/or principal cash flows on an existing borrowing in a cash flow hedge.
2. Foreign exchange differences arising from translating the results and financial position of a foreign operation into a single presentation currency in the consolidated financial statements are recognised in other comprehensive income (until disposal of the foreign operation). Such translational FX risk can be hedged in a net investment hedge of the foreign currency risk arising on the foreign operation.

4.1.2 General hedge accounting rules

What can be designated as hedged items?

A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation (MoA 46.56).

Intra-group transactions and items

The general rule in IFRS 9 is that only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity and that will affect Group P&L can be designated as hedged items. Such intra-group transactions can be designated as hedged items only in the individual or separate financial statements of those entities, and not in the consolidated financial statements of the reporting group, except for transactions between an investment entity and its subsidiaries measured at FVTPL in the investment entity's consolidated accounts (MoA 46.84).

There are, however, two exceptions to this general rule involving foreign currency exposures:

- Foreign exchange gains and losses on intra-group monetary items, and
- Forecast intra-group transactions (MoA 46.85).

Under IAS 21, foreign exchange gains and losses on an intra-group monetary asset (or liability) between group entities with different functional currencies, whether short-term or long-term, do not fully eliminate in the consolidated P&L. A foreign currency monetary item represents a commitment to convert one currency into another and exposes the reporting entity to a gain or loss through currency fluctuations. Accordingly, in the reporting entity's consolidated financial statements, such exchange differences continue to be recognised in P&L. The foreign currency exposure on such an intra-group monetary item can therefore be designated as a hedged item on consolidation (MoA 46.86).

When hedging forecast intra-group transactions, the group member entering into the forecast transaction can be a parent, subsidiary, associate, joint arrangement or branch. The ability to hedge such intra-group forecast transactions is subject to two conditions. The first condition is that the intra-group transaction is denominated in a currency other than the functional currency of the group member entering into such a transaction. This is necessary because, under IAS 21, a foreign currency exposure arises only where a transaction is denominated in a currency other than the functional currency of the entity entering into that transaction.

The second condition is that the foreign currency risk will affect the group's consolidated P&L. This condition will be met only when the forecast intra-group transaction is related to an external transaction. An example is forecast sales or purchases of inventories between members of the same group, where there will subsequently be an onward sale of the inventory to a party external to the group. However, if there is no external related transaction (which is usually the case for royalty payments, interest payments or management charges between members of the same group), the foreign currency risk of those forecast intra-group transactions would not affect consolidated P&L, and so cannot qualify as hedged items.

Forecast intra-group foreign currency dividends can never qualify as hedged items (MoA 46.88).

Hedging groups of net positions in a cash flow hedge

As noted in section 4.1.1, treasurers commonly group similar risk exposures and hedge only the net position. IFRS 9 allows the accounting approach to reflect this risk management strategy in circumstances where:

- the hedge is of foreign currency risk
- if the hedge is a cash flow hedge, the designation and hedge documentation of the net position specifies the reporting period in which the forecast transactions are expected to affect P&L, as well as their nature and volume (MoA 46.60).

PwC insight

The ability to hedge net positions under IFRS 9 allows hedge designation in a way that is consistent with an entity's risk management strategy. However, IFRS 9 requires, in a cash flow hedge, the gains and losses on recycling be presented as a separate line item in P&L (separate from the hedged items), and so it does not allow an entity to present the post-hedging results of its commercial activities for those line items. This may mean the ability to hedge net positions is not as widely used as it might otherwise have been.

In addition, net nil positions (that is, where hedged items among themselves fully offset the risk that is managed on a group basis) are also allowed to be designated in a hedging relationship that does not include a hedging instrument, provided that all of the following criteria are met:

- the hedge is part of a rolling net risk hedging strategy (that is, the entity routinely hedges new positions of the same type);
- the hedged net position changes in size over the life, and the entity uses eligible hedging instruments to hedge the net risk;
- hedge accounting is normally applied to such net positions; and
- not applying hedge accounting to the net nil position would give rise to inconsistent accounting outcomes (MoA 46.63).

What can be designated as hedging instruments?

Derivative instruments

Most derivative financial instruments, except for some written options, can be designated as hedging instruments, provided they are entered into with an external party (MoA 46.99). A qualifying instrument must be designated in its entirety as a hedging instrument (with a few exceptions).

PwC insight

It is possible to use one derivative to hedge multiple risks. This can be useful for treasury centres because it provides them with additional flexibility in their dealings with the external market. For example, the entity can enter into a single derivative instrument to hedge its exposure to interest rate risk as well as foreign currency risk stemming from different sources, or even multiple currencies. Hedging multiple independent exposures will often lead to multiple hedge relationships, which requires separate tracking of the various risk elements in the derivative. This is often achieved by imputing an additional leg to 'split' the derivative into component parts. Remember, though, that the entire derivative needs to be included in hedge relationships. This means that if one of the hedging relationships fails the hedging criteria, hedge accounting must be discontinued for all of the hedge relationships that use any component of the same hedging instrument (FAQ 46.129.2).

Internal derivative contracts used to transfer risk exposures between different entities within a group, or divisions within a single legal entity, cannot be designated as hedging instruments if the derivative contracts are internal to the entity being reported on. Thus, intra-group derivatives or other balances do not qualify as hedging instruments in consolidated financial statements irrespective of whether a proposed hedging instrument, such as an intercompany borrowing, will affect consolidated profit or loss. Nor can they be designated as hedging instruments in the individual or separate financial statements of a legal entity for hedging transactions between divisions in the entity. IFRS 9 makes it clear that only instruments that involve a party external to the reporting entity (that is, a group or an individual entity that is being reported on) can qualify as designated hedging instruments, though they might qualify in the separate financial statements of individual entities in the group (FAQ 46.99.1).

PwC insight

It is not uncommon for entities to try to use intra-group borrowings to hedge their net investments in foreign operations. As discussed above, this is not possible because the borrowing will be eliminated on consolidation. However, if an internal contract is offset with an external party, the external contract could be designated as the hedging instrument, and the hedging relationship might qualify for hedge accounting. In such situations, the hedging relationship consists of the external instrument and the item that was the subject of the internal hedge. The internal derivative is often used as a tracking mechanism to relate the external derivative to the hedged item.

Indeed, many entities take advantage of this to net risk through a central treasury function and, thereafter, to hedge the net exposure by entering into external contracts with third parties. This avoids the cost of each subsidiary entering into contracts with third parties, some of which might offset one another (FAQ 46.99.1).

Non-derivative instruments

Non-derivative financial instruments are also eligible hedging instruments in hedges of FX risk. As such, derivatives and non-derivative instruments (or a combination of both) may be designated as hedging instruments in a hedge of net investment in a foreign operation (MoA 46.97-98). IFRIC 16 further clarifies that for the purpose of a net investment hedge, the hedging instrument(s) may be held by any entity or entities within the group, provided the designation, documentation and effectiveness requirements of IFRS 9 are met.

4.1.3 Hedges of net investments in foreign operations

Net investment hedges are subject to slightly different rules compared with other types of hedges, reflecting their different nature. Many of these differences are highly relevant for group structures with (multiple) intermediate holding entities and/or centralised treasury centres. IFRIC 16 contains the following requirements for net investment hedges:

- Hedge accounting may be applied only to the foreign exchange differences between the functional currency of the foreign operation and the parent entity's functional currency.
- The hedged item can be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation in the consolidated financial statements of the parent entity. The carrying amount of the net assets of a foreign operation that may be designated as the hedged item in the consolidated financial statements of a parent depends on whether any lower level parent of the foreign operation has applied hedge accounting for all or part of the net assets of that foreign operation and that accounting has been maintained in the parent's consolidated financial statements.
- The hedged risk may be designated as the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of any parent (for example, the immediate, intermediate or ultimate parent entity) of that foreign operation. The fact that the net investment is held through an intermediate parent does not affect the nature of the economic risk arising from the foreign currency exposure to the ultimate parent entity.

- An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once in the consolidated financial statements. A hedging relationship designated by one parent entity in its consolidated financial statements need not be maintained by another higher level parent entity. However, if it is not maintained by the higher-level parent entity, the hedge accounting applied by the lower-level parent must be reversed before the higher-level parent's hedge accounting is recognised.

The hedging instrument may be held by any entity within the group, including the treasury centre, not just the parent. When net investment hedge accounting is applied, the foreign currency gains or losses on the hedging instrument are deferred in OCI (to the extent that the net investment hedge is effective) until the subsidiary is disposed of or liquidated, at which point they become part of the gain or loss on disposal.

PwC insight

Hedging a net investment with a foreign currency loan can often result in the closest thing IFRS 9 allows to a perfect hedge relationship within the group financial statements. However, hedging with derivatives creates additional complexity in the form of discounted spot, forward points and/or currency basis. Treasury centres may also face additional complexities where, for example, they hold the external derivative and have a different functional currency from the parent entity with the exposure. Specifically, the following two questions arise:

1. How should the hedge effectiveness assessment be performed in the consolidated financial statements where the hedging instrument held by a Treasury centre results in a translation gain or loss (due to a different functional currency)?
2. Does the group need to apply full or partial elimination of intercompany derivatives in the consolidated financial statements (for internal gains/losses)?

These issues are addressed further in illustrative example EX 4.4.1 below.

When an entity disposes of a foreign operation that was hedged in a net investment hedge, the amount included in that parent's foreign currency translation reserve in respect of that foreign operation is reclassified to P&L. In addition, an amount from the foreign currency translation reserve in respect of the hedging instrument should also be reclassified or 'recycled' to P&L. Recycling has been a topic of considerable confusion and debate when a foreign operation is only partially disposed of. The IFRS IC discussed this issue and included a brief example illustrating its conclusions in IFRIC 16 paragraph AG8. The table below illustrates common situations where an entity might partially dispose of a foreign operation together with the resulting effect on hedging reserves.

Hedging reserves refer to the cash flow hedge reserve in the subsidiary itself and the net investment reserves in the consolidated financial statements.

Relationship of foreign operation before disposal	Relationship of foreign operation after disposal	Reclassification of hedging reserves
Subsidiary	Subsidiary (with new non-controlling interest (NCI) recognised)	Re-attribute share of hedging reserves to NCI(s). No amount reclassified to profit and loss.
Subsidiary	Associate	Reclassify 100% of hedging reserves related to foreign operation to profit and loss as part of gain or loss on disposal of subsidiary.
Associate	Associate	Reclassify proportionate amount of share of hedging reserves to profit and loss as part of gain or loss on partial disposal of an associate.
Associate or subsidiary	Financial asset	Reclassify 100% of share of hedging reserve related to foreign operation to profit and loss, as above.

(EX 46.32.2).

4.2 Frequently asked questions

4.2.1 Can inter-company borrowings be designated as a hedging instrument in a net investment hedge to eliminate accounting mismatches?

Illustration

A Swiss parent company (Parent) with CHF as its functional currency has a treasury company (TCo) with EUR as its functional currency. Parent also has a second subsidiary (SubCo) with a EUR functional currency.

TCo borrows a EUR loan and transfers the proceeds to Parent via an intercompany EUR loan. Parent, in turn, lends the proceeds to SubCo.

SubCo is dependent on parent financing and therefore Parent accounts for its loan to SubCo as part of its investment in SubCo (i.e. a quasi-equity loan). This creates an accounting mismatch in the financial statements of Parent as the retranslation of the loan from TCo will be recognised in P&L, while there will be no FX gain/loss on the loan to SubCo (because this will be recognised in CTA as part of the retranslation of the net investment).

Since the intercompany loan is clearly linked with an external transaction (the external borrowing held by TCo), can Parent designate it as a hedging instrument in a net investment hedge of Parent's investment in SubCo in the consolidated financial statements of the Swiss Group?

Solution

No, intercompany monetary items are not eligible hedging instruments (but can be eligible hedged items), as explained in IFRS 9 BC.149.

It is only possible to designate hedging instruments that are external to the reporting entity (i.e. the Group) in accordance with IFRS 9 paragraph 6.2.3. While, in accordance with IFRIC 16.14, the external borrowing held by TCo can be designated as a hedging instrument in the consolidated financial statements of Parent, this borrowing is in the functional currency of the borrower and hence would not impact the accounting for either the loan or the foreign exchange gains and losses resulting from translation of the intercompany loan. (FAQ 46.99.4)

4.2.2 Using a single derivative instrument to hedge more than one risk in more than one hedged item

Question

Can a single hedging instrument be designated in a hedge of multiple risks?

Illustration

Entity A's functional currency is the Japanese yen (JPY). Entity A has a five–year floating–rate US dollar liability and a five–year fixed–rate pound sterling–denominated bond (an asset). The principal amounts of the asset and liability, when converted into Japanese yen, are the same. Entity A enters into a single foreign currency forward contract to hedge its foreign currency exposure on both instruments, under which it receives US dollars and pays pounds sterling at the end of five years.

Entity A designates the forward exchange contract as a hedging instrument in a cash flow hedge against the foreign currency exposure on the principal repayments of both instruments. Since entity A's functional currency is yen, it is exposed to USD/JPY foreign currency risk on the floating–rate liability, and JPY/GBP foreign exchange risk on the fixed–rate asset.

Can the forward exchange contract be designated as a hedge of both of the risks described above?

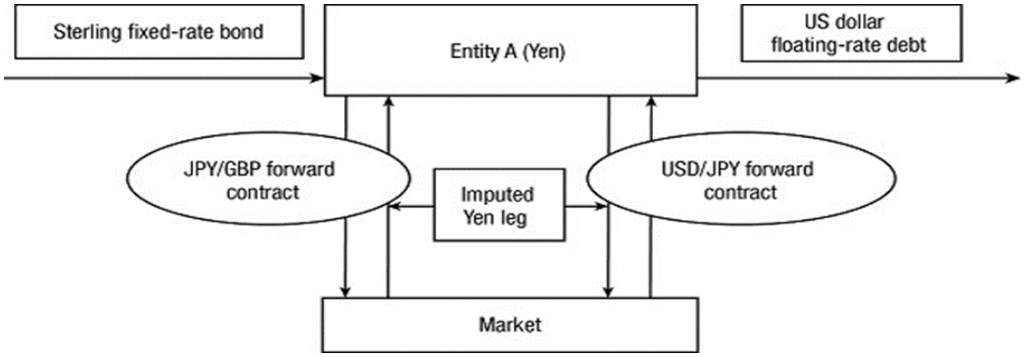
Solution

Yes. IFRS 9 permits a single hedging instrument to be designated as a hedge of multiple types of risk, provided it is documented and designated in accordance with paragraph B6.2.6 of IFRS 9, as follows:

- The risks hedged can be identified clearly. The risks are the exposures to changes in the forward exchange rates between US dollars and yen, and yen and pounds, respectively. The hedged items are the principal amounts of the liability and the note receivable in their respective currency of denomination.
- The economic relationship can be demonstrated. For the pound sterling bond, the effectiveness could be measured as the degree of offset between the fair value of the principal repayment in pounds sterling and the fair value of the pound sterling payment on the forward exchange contract. For the US dollar liability, the effectiveness could be measured as the degree of offset between the fair value of the principal repayment in US dollars and the US dollar receipt on the forward exchange contract.

It should be noted that, in respect of the second bullet point above, the USD/GBP forward is theoretically divided into two different derivatives. The yen is imputed as the base currency for the two derivatives, creating a synthetic USD/JPY (receive US dollar, pay yen) foreign currency forward, and a synthetic JPY/GBP (receive yen, pay sterling) foreign currency forward.

The synthetic yen leg is defined in such can be pictorially represented as follows:



Furthermore, it should be noted that the hedge accounting criteria must be satisfied for both of the designated hedged risks. For instance, if one of the hedged risks no longer exists, both hedges must be discontinued. This is because a derivative instrument must be fair valued and used as a hedging instrument in its entirety, apart from the specific exemptions set out in IFRS 9 paragraph 6.2.4.(FAQ 46.129.2)

4.3 Illustrative example

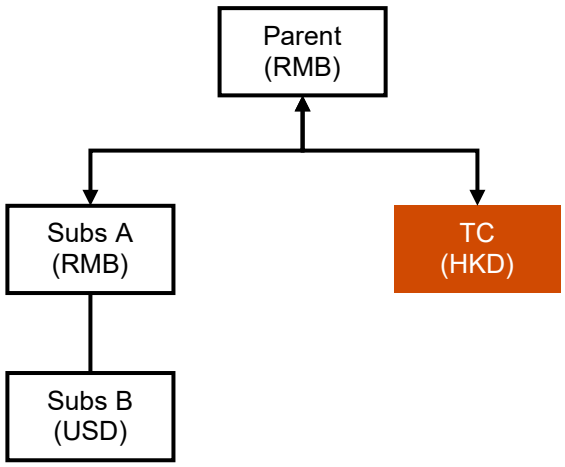
4.3.1 Hedging through a treasury centre having a different functional currency than the parent

The following example illustrates a common structure where a treasury centre acts as the gateway to the financial markets and writes back-to-back internal derivatives that mirror the external transaction with the group entities holding the underlying risk exposures.

Different functional currencies between the treasury centre and the entity with the underlying exposure can create challenges when hedging with derivatives, and this example explains possible ways of addressing this issue.

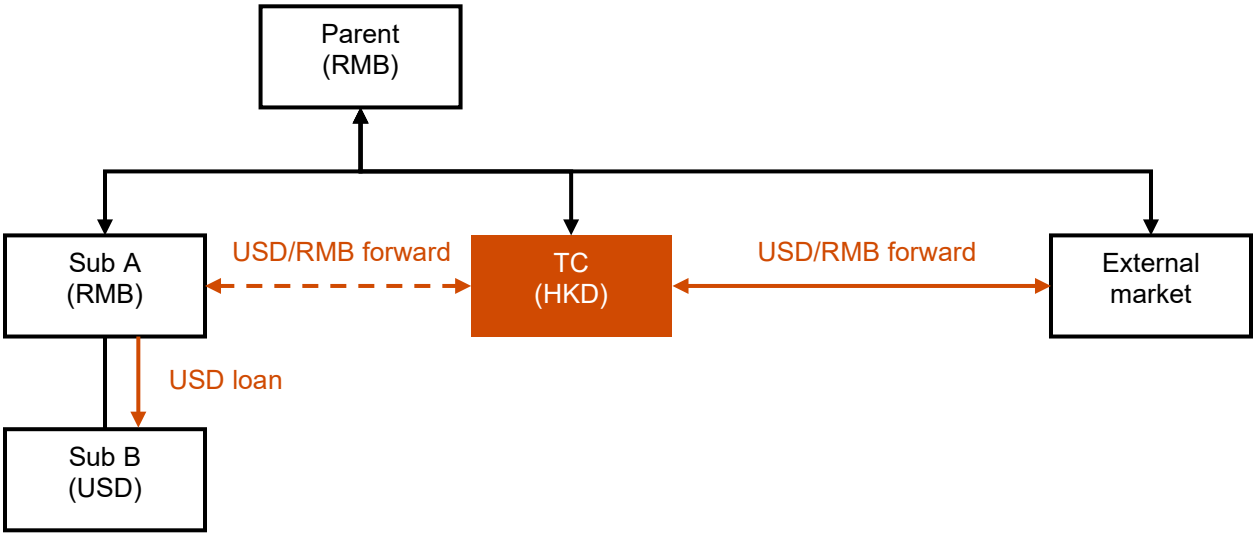
Background and assumptions

Parent, a Chinese company with RMB functional currency, has a Chinese subsidiary, Sub A, with RMB functional currency and a treasury centre (TC) with HKD functional currency. Sub A has a substantial investment in Sub B, whose functional currency is USD. Parent, being the ultimate parent entity, presents its consolidated financial statements in RMB. Parent's reporting date is 31 December. The group structure is illustrated below:



On 1 January 20X1, Sub A lends USD 100 million to Sub B. The loan is repayable on 31 December 20X2 and hence is not considered to be part of Sub A's net investment in Sub B. The intercompany lending creates USD/RMB exposure for Sub A, which will affect the group's consolidated profit or loss. It therefore wishes to hedge the principal on the loan using a foreign currency forward contract to buy RMB and sell USD.

In accordance with group policies, TC acquires the forward contract in an external transaction and enters into a back-to-back internal forward with Sub A that mirrors exactly the terms of the external forward:



The external foreign currency forward contract entered into as a hedge of the USD principal repayment of the intercompany loan has the following terms:

Type	Forward contract
Amount purchased	RMB 554,737,911
Amount sold	USD 100,000,000
Forward rate	USD 1 = RMB 5.5474
Spot rate at inception	USD 1 = RMB 5.7693
Start date	01 Jan 20X1
Maturity date	31 Dec 20X2

Market rates on key dates during the hedge are as follows:

	01 Jan 20X1	31 Dec 20X1*
USD/RMB spot rate	5.769	6.009
USD/RMB forward rate	5.547	5.824
RMB/HKD spot rate	1.335	1.250
USD/HKD spot rate	7.700	7.512

*Only the first period of the hedge relationship is covered in this illustrative example

The Group applies cash flow hedge accounting and IFRS 9's hedge accounting requirements are satisfied.

In the consolidated financial statements the Group has designated the hedge relationship as follows:

Hedged item	The USD principal repayment of the intercompany loan receivable recognised in Sub A
Hedging instrument	The external forward entered by TC
Hedged risk	USD/RMB spot foreign exchange risk arising from the USD principal repayment of the intercompany loan receivable at maturity

PwC insight

An entity has a choice of three accounting approaches for hedges of a foreign currency risk using a forward contract:

1. forward rate designation;
2. spot rate designation with changes in the value of forward points recognised in P&L; and
3. spot rate designation with changes in the value of forward points deferred in OCI

The choice can be made on a hedge by hedge basis. Ineffectiveness may arise if the timing of the forecast transaction does not match the maturity of the forward contract whichever designation is used. This is because IFRS 9 requires the time value of money to be considered when measuring hedge ineffectiveness; discounted amounts must be used for this purpose.

If the entity uses a spot rate designation with forward points recognised in P&L, changes in the value of these forward points will give rise to additional volatility in profit or loss.

For simplification purposes, the following assumptions have been applied:

- The cost of hedging approach to the forward points is not presented.
- Foreign currency basis spreads, credit risk and discounting are ignored.
- Deferred taxes are not presented.

Extracts from hedging policies

Hedging instruments

Only vanilla forward contracts are used to hedge foreign exchange risk. All derivatives must be entered into with counterparties with a credit rating of A or higher.

Hedging relationship

Only the spot element of the forward contract is designated as the hedging instrument and therefore only the spot component is included in the hedge relationship (i.e. the forward points are excluded from the hedge relationship and recognised in other comprehensive income).

Hedge documentation

At the inception of a hedging relationship management should formally document the hedging relationship including:

- risk management objective and strategy;
- identification of the hedging instrument, the hedged item, the nature of the risk being hedged (USD/RMB spot exposure) and potential sources of ineffectiveness; and
- description of how management will assess whether the hedging relationship meets the hedge effectiveness requirements, including that (a) there is an economic relationship between the hedged item and hedging instrument, (b) credit risk does not dominate the value changes that result from the economic relationship, and (c) the hedge ratio in the hedge relationship is the same as the quantity of the hedged item and of the hedging instrument that the entity actually uses for hedging purposes.

Hedge effectiveness

Parent will assess on an ongoing basis, whether the hedging relationship meets the hedge effectiveness requirements. At a minimum, Parent will perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. The assessment relates to expectations about hedge effectiveness and therefore is only forward-looking.

Consistent with the risk management policy and nature of risk exposure, hedge effectiveness requirements are demonstrated based on critical terms (amount, currency, maturity date). Under Parent's policy, management is therefore required to align the characteristics of the hedging instrument to those of the hedged item (notional amount, currency and maturity).

In the hedge documentation, management will demonstrate on the basis of a qualitative assessment of those critical terms that an economic relationship exists meaning that the hedging instrument and the hedged item have values that will generally move in opposite directions because of the same risk, which is the hedged risk.

Accounting entries

If the criteria for applying cash flow hedge accounting are met, the accounting entries during the duration of the hedge are as follows:

- Changes in fair value related to the change in spot rate of the hedging instrument ('change in fair value attributable to spot') are recognised in other comprehensive income (and in the cash flow hedge reserve in equity). This is the hedged risk. The standard does not prescribe how this should be calculated, but it requires time value of money to be considered. As such Parent calculates this change in fair value by identifying at inception of the hedge which part of the expected cash flows is related to the spot rate ('the spot component') expressed in functional currency. At each testing date this spot component is recalculated using the market spot rate at the time of calculation. This change is discounted to identify the part of the fair value change which is related to change in spot risk taking into account time value of money.
- Changes in fair value of the forward points are recognised in other comprehensive income (and in the cost of hedging reserve in equity) to the extent that they relates to the hedged item.
- When the underlying hedged item impacts profit or loss (that is, USD/RMB spot revaluation charged to the income statement in respect of the USD 100m loan), an amount is recycled from the hedge reserve to offset this impact in profit and loss.
- Any ineffectiveness in the relationship is recognised directly in P&L.

Extracts from hedge documentation

Parent's hedge documentation is as follows:

Risk management objective

In order to comply with Parent's foreign exchange risk management strategy as described above, the foreign exchange risk arising in Sub A from the USD principal repayment of the intercompany loan receivable recognised in Sub A, repayable on 31 December 20X2 and detailed below, is hedged.

Hedging relationship

Cash flow hedge: hedge of the foreign currency risk arising from the USD principal repayment of the intercompany loan receivable recognised in Sub A.

Nature of risk being hedged

USD/RMB spot foreign exchange risk arising from the USD principal repayment of the intercompany loan at maturity on 31 December 20X2.

Identification of hedged item

The hedged item is the intercompany loan receivable recognised in Sub A with the following characteristics:

USD intercompany loan	
TMS reference	12101
Type	Intercompany loan with fixed coupon
Notional amount	USD 100,000,000
Issue date	01 Jan 20X1
Maturity date	31 Dec 20X2
Coupon rate	2.50%
Settlement dates	30 June and 31 December each year

Identification of hedging instrument

The hedging instrument is a plain vanilla forward contract to sell USD 100,000,000 with the following characteristics:

RMB/USD forward contract	
TMS reference	F1234
Type	Forward contract
Amount sold	USD 100,000,000
Amount purchased	RMB 554,737,911
Forward rate at inception	USD 1 = RMB 5.547
Spot rate at inception	USD 1 = RMB 5.769
Spot component at inception	RMB 576,925,252
Maturity date	31 Dec 20x2

Only changes in the spot component of the forward contract are designated as the hedging instrument.

The terms of the forward contract are fully aligned with the critical terms of the hedged item.

Hedge effectiveness

In order to qualify for hedge accounting, the following effectiveness requirements have to be fulfilled.

a. **Economic relationship**
In accordance with 'the cash flow hedge on foreign exchange currency exposure policy', critical terms are applied to assess qualitatively the economic relationship between the hedging instrument and the hedged items.

The hedged item creates an exposure to buy USD 100m and sell RMB. The forward contract is to sell USD 100m and buy RMB. Since the hedged exposure is exactly matched by the USD leg of the forward contract (that is, they are both the same amount of USD with the same payment date), and the remaining leg is a fixed cash flow in Sub A's functional currency, there is a clear economic relationship between the hedging instrument and the hedged item.

b. **Effect of credit risk**
Since credit risk is not part of the hedged risk, the credit risk of TC only impacts value changes of the hedging instrument.

Credit risk arises from the credit rating of TC and the counterparty to the forward contract. Group Treasury monitors the company and the bank's credit risk for adverse changes. The credit risk associated with TC and the bank is considered minimal and at inception does not dominate the value changes that result from the economic relationship (that is, the effect of changes in USD/RMB). This will be re-assessed in cases where there is a significant change in either party's circumstances.

c. Hedge ratio

The hedge ratio is based on a forward contract with a notional amount of USD 100,000,000 and an inter-company loan with a principal amount of USD 1000,000,000. This results in a hedge ratio of 1:1 or 100%.

Sources of ineffectiveness

The following potential sources are identified:

- changes in timing of the payment of the hedged item;
- reduction in the notional amount of the hedged item; and
- a change in the credit risk of TC or the bank counterparty to the forward contract.

PwC insight
The impact of foreign currency basis spreads has been ignored for simplification purposes. However, in reality this would represent a source of ineffectiveness in the relationship (IFRS 9 para B6.5.5) unless it is excluded from the designated hedging instrument.

Frequency of assessing hedge effectiveness

Hedge effectiveness is assessed at inception of the hedge, at each reporting date (31 December), and upon a significant change in the circumstances affecting the hedge effectiveness requirements.

Items excluded from the assessment of hedge effectiveness

All changes in fair value of the derivative instrument attributable to changes in the forward rate between the USD and RMB will be excluded from assessment of hedge effectiveness, because the hedged risk has been designated as changes in the spot rate. Such amounts will be deferred as a component of OCI.

Assessing economic relationship and journal entries

1 January 20X1

Assess economic relationship

As described in the hedge documentation, the critical terms of the hedging instrument and the hedged items match perfectly. Therefore, management can qualitatively assess that there is an economic relationship between the hedging instrument and the hedged item and that they will generally move in the opposite direction.

Conclusion: The hedge effectiveness requirements are met.

Inception of debt and forward

The intercompany loan is recorded in the separate financial statements of Sub A and Sub B in the respective functional currencies. The intercompany balances will be eliminated upon consolidation.

No accounting entry is made in respect of the forward contract, because the fair value is nil.

31 December 20X1

Hedge effectiveness assessment

The hedge continues to meet the effectiveness requirements, because there has been no change in the hedging relationship or hedge ratio (that is, no change in notional amount, no change in the credit risk of the counterparties, and no change in sources of ineffectiveness).

Conclusion: The hedge effectiveness requirements are met.

Fair value forward

All of the criteria for hedge accounting are met for the period ended 31 December 20x1. Cash flow hedge accounting can therefore be applied. Since the hedge has been fully effective for the period, the entire change in fair value of the forward attributable to the spot element is recognised in other comprehensive income.

The change in fair value of the forward can be broken down into changes attributable to the forward points and the spot rate element, as follows:

Forward as at 31 Dec 20X1				**Forward as at 31 Dec 20X1**		
Full fair value (in millions)				**Change in FV attributable to spot (in millions)**		
Notional amount in USD	(100)	USD		**Notional amount in USD**	(100)	USD
Forward rate at valuation date	5.824			**Spot rate at valuation date**	6.009	
RMB equivalent (A)	(582.4)	RMB		**Spot component at valuation date (C)**	(600.93)	RMB
RMB contracted amount (B)	554.74	RMB		**Spot component at inception (D)**	(576.93)	RMB
Change in fair value (A+B)	**(27.70)***	**RMB**		**Change of spot component (C-D)**	**(24)**	**RMB**
Translation to functional currency	(23.08)	HKD		**Translation to functional currency**	(30)	HKD

***The change in the forward points of (3.70) is ignored for simplicity.**

For consolidation purposes, TC's separate financial statements (HKD) are translated to the group's presentation currency (RMB). The income statement is often translated at the average rate for the period (assuming this rate approximates the exchange rates at the dates of the transaction), while the statement of financial position is translated at the closing rate. Exchange differences between the closing rate and average rate are recognised in CTA in accordance with IAS 21. The gain or loss on the forward contract recognised in the consolidated financial statements is therefore different from that of the hedged item due to the effect of the translation of TC's separate financial statements (HKD) to the presentation currency (RMB), as follows:.

Revaluation of the forward contract (in millions)	**RMB**	**HKD**
The fair value attributable to the spot component of the forward is determined in accordance with the contractual terms of the USD/RMB forward contract. Cumulative changes in fair value are derived from the movement of the fair value from the inception of the hedge to the date of hedge effectiveness assessment.	FV loss = (24)	
a. TC's financial statements The fair value attributable to the spot component of the forward is recognised in TC's statement of financial position at the closing rate of each reporting period. The movement in this balance is recognised in profit or loss.		FV loss = (30)
b. Parent's consolidated financial statements TC's financial statements will be translated to RMB (the presentation currency) for consolidation purposes, as follows: – Derivative liability (spot component) is translated using closing rate of each reporting period (derivative liability at closing rate = RMB (24)); – The fair value gain/(loss) (spot component) is translated at the average rate of each reporting period (fair value loss at average rate = RMB (25)); – All resulting exchange differences between average and closing rate are recognised in other comprehensive income - Currency translation account (CTA).	FV loss = (25) CTA = 1	

Helpful hint

The change in fair value of the forward in Parent's consolidated financial statements represents the aggregate of exchange differences recognised in CTA (RMB 1m) and the translated fair value gains and losses in the consolidated profit or loss (RMB (25)m). Consequently, the functional currency of TC does not affect the fair value measurement of the forward, or the amount recognised in the statement of financial position, but will result in a different fair value gain or loss in the consolidated financial statements due to the effect of translation to the presentation currency.

This difference could be seen to create ineffectiveness in the consolidated financial statements albeit that the external forward, together with the back-to-back derivative, represent a perfect hedge against the FX risk arising on the inter-company loan. However, we believe that the interaction between IFRS 9 and IAS 21 is such that the fair value measurement of a financial asset or financial liability is first determined in the foreign currency in which the item is denominated in accordance with IFRS 9.

Accordingly, the fair value movement used for hedge effectiveness testing is also measured in this foreign currency. Thereafter, IAS 21 is applied to translate the foreign currency amount into the presentation currency (paragraph B5.7.2 of IFRS 9)

In this example, the total fair value gain or loss on the hedging instrument will be measured in RMB and compared to the fair value gain or loss on the hedged item. Because the hedging instrument perfectly offsets the hedged item, the total fair value gains or loss on the hedging instrument (RMB (24)m) is recognised in OCI. Subsequently, the fair value gains or loss on the hedging instrument is translated to the functional currency and then to the presentation currency in accordance with IAS 21, giving rise to the translated fair value gain on the external forward (RMB (25)m) and the related translation difference (RMB 1m) to be recognised in the hedge reserve and CTA in other comprehensive income, respectively.

This reflects the risk management objective of the Group, which in this case is to have a perfect match between hedged item and hedging instrument.

The entry is as follows (in m)	**DR**	**CR**	
Derivative		24	RMB
OCI - CTA		1	RMB
OCI - Cash flow hedge reserve	25		RMB
Cash flow hedge – change in fair value of the swap			

Revaluation and elimination of intercompany borrowing

The application of normal consolidation procedures includes the elimination of intragroup balances and transactions. Intra-group monetary assets (or liabilities) cannot be eliminated against the corresponding intra-group liabilities (or assets) without showing the results of currency fluctuations in the consolidated financial statements (IAS 21.45), and accordingly a gain of RMB 24m will also be recognised in profit or loss from the translation of the borrowing.

The entry is as follows (in millions)	**DR**	**CR**	
Intercompany loan asset	24		RMB
Foreign exchange difference (income statement)		24	RMB
Retranslation of intercompany borrowing by Sub A			

Recycling hedge reserve

Since the hedged item (foreign currency intercompany loan) has already affected profit or loss, the amount deferred in the cash flow hedge reserve is reclassified to profit or loss as a reclassification adjustment.

Helpful hint

Since the hedge is a perfect hedge from a risk management standpoint and only the translation to the presentation currency creates the difference of RMB 1m, we believe it is acceptable to reclassify to profit or loss not only the full cash flow hedge reserve but also the amount recognised initially in CTA. This avoids a remaining balance existing at the end of the hedge relationship.

The accounting entry to release the amount in the hedge reserve to hedge the foreign exchange difference recognised in profit or loss on the intercompany loan:

The entry is as follows (in millions)	**DR**	**CR**	
OCI – Cash flow hedge reserve		25	RMB
OCI – CTA	1		RMB
Foreign exchange difference (income statement)	24		RMB
Recycling of hedge reserve to P&L			

Helpful hint

Further complexities will arise when treasury centres hedge multiple highly probable cash flows not derived from existing monetary items, as the entity will need to track the amount of CTA associated with each hedge relationship.

B. Cash and liquidity risk management considerations

5. Cash and liquidity risk management

Treasurers and treasury centres may have many roles within an organisation but an essential responsibility typically involves managing the cash of the business and addressing two key questions: Where is the cash held, and how much do we have?

In order to be able to address these questions, the treasurer typically will be responsible for liquidity management at group level and monitor it for all of the entities within the group. This will often include monitoring current and expected cash flows and appropriately investing excess cash, or being prepared to borrow funds where necessary. Such borrowings may take different forms. See section 6 below for further details on the accounting for non-standard forms of borrowing such as debt factoring and supply chain finance.

Investors, suppliers, tax authorities and others are very interested in cash or currency held by or readily available to an entity, because it provides them with information on the liquidity of the entity. They rely on information in the financial statements and therefore it is important that the presentation of cash and cash equivalents is consistent with accounting standards. A first key point for the treasurer is therefore to understand what can be reflected as cash and cash equivalents from an IFRS reporting perspective.

Different instruments, such as physical or notional cash pooling or virtual accounts, are available to treasurers to balance the liquidity of the group's available funds with the ability to earn a return on excess cash. Treasurers will also need to understand the accounting treatment and presentation of such instruments.

Additionally, the increasing development of digital currencies provides another means of investing and paying for goods, and it further complicates the accounting. Refer to our In depth: Cryptographic assets and related transactions: accounting considerations under IFRS available on viewpoint.pwc.com for guidance on some of the issues in accounting for such instruments.

5.1 Cash and cash equivalents – definitions

Paragraph 6 of IAS 7 defines cash and cash equivalents as follows:

- Cash is '*cash on hand and demand deposits'*.
- Cash equivalents are **'***short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value'*.

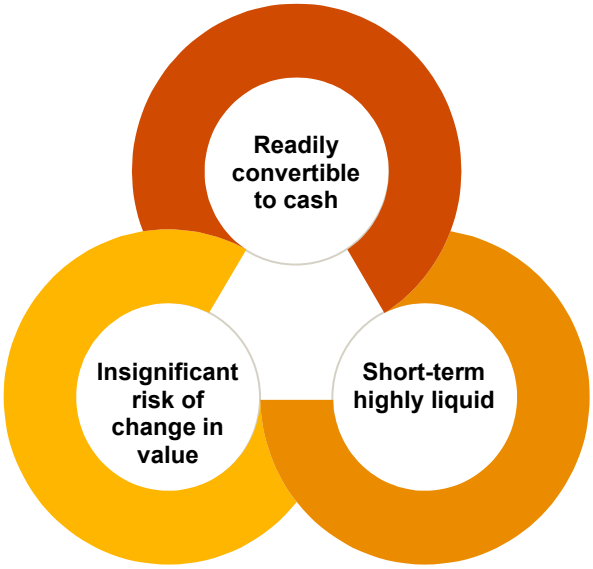
A two-step assessment is typically performed to determine if an instrument is 'cash or cash equivalents': Firstly, the instrument should be assessed against the definition of 'cash'. Only once determined not to be 'cash', should consideration be given to whether the instrument is a 'cash equivalent'. This distinction was clarified in the IFRS IC agenda decision *'Demand Deposits with Restrictions on Use arising from a Contract with a Third Party (IAS 7)*' published in April 2022.

It is important to clearly define what an entity considers to be cash and cash equivalents and items not meeting these definitions will need to be presented in a different line in the financial statements (for example, short term investments or other debtors). The treatment in the cash flow statement and statement of financial position (balance sheet) may also differ and need to be explained and reconciled. Finally, local statutory or regulatory requirements may also impact how cash equivalents or similar balances can be presented in the balance sheet.

Basic cash on hand may be straightforward to identify. However, there is no definition of demand deposits in the IFRS Accounting Standards. It is generally accepted that deposits with financial institutions that are repayable on demand and available within 24 hours or one working day, without penalty, can be considered demand deposits (FAQ 7.3.1).

Any instruments where repayment can occur after one day may not be considered as cash but can still meet the definition of cash equivalents, provided all criteria for being a cash equivalent are met.

Identifying cash equivalents is not always straightforward. The definition of cash equivalents has three related components which should be looked at together:



Maturity (short-term, highly liquid)

An investment requires a 'short maturity' to meet the definition of a cash equivalent. An investment with a maturity period of three months or less from the acquisition date will generally qualify as a cash equivalent, provided that it is used for cash management purposes.

Any investment, such as a government bond or certain deposit certificates, purchased with a maturity period of more than three months, without an early redemption option, will not be a cash equivalent, because its maturity period exceeds the short-term period suggested by the standard. Moreover, such an investment will not become a cash equivalent when its remaining maturity period (measured from a subsequent balance sheet date) becomes three months or less, because the maturity period is measured from the acquisition date (see FAQ 7.5.2).

The limit on maturity is arbitrary, but it reinforces that the amount of cash receivable should be known at the time of the initial investment and be subject to an insignificant risk of change in value in response to changes in interest rates and capital values. There could be limited circumstances in which deposits with a term of more than three months might be classified as cash and cash equivalents. (FAQ 7.3.3).

Readily convertible to cash

The term 'readily convertible' implies that an investment must be convertible into cash without an undue period of notice and without incurring a significant penalty on withdrawal. Monies deposited in a bank account for an unspecified period, but which can only be withdrawn by advance notice, should be carefully evaluated to determine whether they meet the definition of cash equivalents. Cancellation clauses, termination fees or usage restrictions might affect the redemption amount and create a more than insignificant risk of change in value. (FAQ 7.3.3)

Where the counterparty to a short-term investment experiences financial problems, there may be some doubt over its ability to fulfil the agreement's requirements. In these instances the investment should not be classified as a cash equivalent, because there is a risk that the instrument will not be readily convertible or that the redemption obligation will not be met (FAQ 7.3.4).

Held for the purpose of meeting short-term cash commitments

For an instrument to be regarded as a cash equivalent, it should not only meet the definition in IAS 7 but also be used as a cash equivalent by the entity that holds it. That is, it should be 'held for the purpose of meeting short-term cash commitments'. For example, an investing company might classify their short-term investments as investments rather than as cash equivalents (FAQ 7.3.2).

The treasurer therefore needs to consider the Group's risk management and liquidity strategy and be able to explain why and how excess cash has been invested and whether it is expected and available to be used within the business in the near term. This will also be necessary for the IFRS 7 liquidity risk management disclosures in the financial statements.

5.2 Restrictions on holdings and use of cash

Certain funds that meet the definition of cash and cash equivalents may have some restrictions and therefore not be fully available for use by the group. This may be the case for escrow accounts where third party approval is necessary to access the funds (FAQ 7.46.2). Cash held by subsidiaries may also have restrictions on transfer to other entities of the group, either through finance agreements with banks, or through currency controls in the country in which the subsidiary operates.

Treasurers should consider whether the funds are restricted in such a manner that the definition of cash and cash equivalents are not met as a result. Only items that are available to meet short-term cash commitments should be classified as cash equivalents in the cash flow statement. One situation where cash is not considered to be restricted is when an entity holds a demand deposit whose terms and conditions do not prevent the entity from accessing the deposit but the entity has agreed with a third party to keep a specified amount of cash in the account and only use that cash for a specified purpose. (IFRS IC agenda decision April 2022) (FAQ 7.46.7).

There may be some situations where cash might be held by subsidiaries operating in countries where exchange control restrictions are in force, such that the cash is not freely transferable around the group. Groups should also consider the implications of restrictions such as sanctions on the accounting and presentation of such balances, including whether an expected credit loss should be recorded. In those cases, disclosure is required of the relevant amounts, along with a commentary on their restriction, although presentation as cash and cash equivalents may still be acceptable (FAQ 7.46.4).

5.3 Electronic transfer of money

While there is a clear trend for faster or instant payments within the corporate world, the majority of payments executed through "classic electronic transfers" still require a number of days in order to be settled. Schemes used to execute those cash transfers electronically usually follow an automated sequence. An example might be:

Day 0—submission: a payment instruction is submitted to the scheme and distributed to the relevant parties overnight.

Day 1—processing: after receiving the instruction, the paying and receiving banks prepare to debit and credit the payer and receiver's accounts, respectively.

Day 2—action: all parties take the action required—thus, the paying bank debits the payer's account and the receiving bank simultaneously credits the receiver's account.

In a treasury centre, the question of recognition and derecognition arises when those collections and payments take place right before the accounting closing date. The settlement usually occurs within the 2-3 days referred to above but it can be even longer in case of a cross border transaction.

Cash outflows

Where a payment is initiated on the day before the accounting closing date and settled 1 or more days after the closing date, diversity in when to reflect the payment in the financial statements currently exists. Some entities might derecognise the creditor liability at the point of transaction initiation (the transaction date) while others might wait for the effective settlement (the settlement date).

Cash inflows

An entity recognises cash as a financial asset on the transfer settlement date (that is, the date when it receives the cash in its bank account), and not before .

PwC insight

The IASB is finalising amendments to IFRS 9 that will clarify how the recognition and derecognition requirements are to be applied to electronic cash transfers.

The amendments will clarify that:

- a financial asset or a financial liability is recognised and derecognised at the settlement date, and
- when a financial liability is settled through an electronic cash transfer, an entity has an accounting policy choice to derecognise the financial liability at the transaction date rather than at the settlement date, if and only if:
  - the entity has no practical ability to withdraw, stop or cancel the payment instruction;
  - the entity has no practical ability to access the cash to be used for settlement as a result of the payment instruction; and
  - the settlement risk associated with the electronic payment system is insignificant.

The amendments will be effective for annual reporting periods beginning on or after 1 January 2026, with retrospective application required. Earlier adoption will be permitted (subject to any endorsement processes).

5.4 Cash pooling

A common method for multinational entities to manage cash balances held around the group is to engage in a cash pooling service with a counterparty bank. As part of this arrangement, a Group might enter into a ‘master netting arrangement’ with a counterparty bank under which the various subsidiary entities of the Group undertake a number of financial instrument transactions with multiple bank accounts. As part of the cash pooling arrangement, the cash held within the group in multiple bank accounts is ‘pooled’ into one balance for the purpose of optimising the cash management of the group.

Cash pooling arrangements may take various forms. Some cash pooling arrangements or virtual account structures might be viewed as a single unit of account for accounting purposes (i.e. a single surplus or overdraft balance), such that the offsetting conditions in IAS 32.42 would not need to be considered. If there is a single unit of account this will likely result in only one entity in the group having a cash balance with the bank, with the other group entities having intercompany receivables/payables instead of cash.

Two of the more common methods seen in practice are as follows:

- Physical pooling (with Zero or target balancing) sometimes referred to as a ‘physical cash sweep’, under which the balances on a number of designated accounts within the group are transferred to a single master account on a regular (usually daily) basis.

- Notional pooling, under which the counterparty bank calculates the net balance on a number of designated accounts, with interest being earned or paid on the net amount. The cash is transferred on a 'notional' basis, that is, the cash remains in the original subsidiary entity's bank account and is not physically swept into the master account within the group.

The existence of cash pooling arrangements within the group may result in a number of accounting issues in both the group and the individual entity financial statements.

For the consolidated balance sheet, the key question is whether the Group should present cash at bank and bank overdraft positions on a gross or a net basis in the consolidated balance sheet.

Key considerations here include whether:

- the bank accounts within the cash pooling arrangement are viewed as one unit or multiple unit of accounts, as referred to above; and
- both of the criteria of paragraph 42 of IAS 32 are met, that is, whether there is both a legally enforceable right to offset, and a clear intention to offset the balances in practice. Refer to section 5.7.4 for further guidance on offsetting considerations.

Physical pooling

Where there is zero balancing at the balance sheet date and no repayment of funding either on the following day or any day thereafter, there is a single cash or overdraft balance, and it is presented as such. The IAS 32 offsetting requirements are not relevant in this case.

Where there is zero balancing at the balance sheet date but the amounts are repaid shortly afterwards there would often be a single cash balance or overdraft. The IAS 32 offsetting requirements are not relevant in this case. However, there may be circumstances where there is a contractual obligation to return the balances to the respective subsidiaries the following day. In such circumstances, these would be considered separate assets or liabilities and the IAS 32 offsetting criteria would be relevant. In this case, the group would not be able to demonstrate the intention to settle on a net basis and therefore would not be able to present the balances net.

For the individual entity's financial statements, in situations whereby the cash is physically swept (zero balancing) at the reporting date, it is likely that the entity will not have any amounts in the bank account and will present its balance sheet on this basis.

Notional pooling

In situations where the cash is notionally pooled and remains in the subsidiary entity bank account, the assessment of the unit of account for the cash pooling arrangement will be important. If the entire cash pooling arrangement is viewed as one unit of account, typically only one entity within the group will reflect cash with the bank in their balance sheet.

Where there is notional pooling, but no physical transfer of balances to one account, the group will not be able to demonstrate the intention to settle net because the arrangement does not actually involve net settlement. Accordingly, the balance should be presented gross.

Where there is notional pooling with regular net settlement, a group will only be able to present notional pool balances net where it has the legal right and an intention to net settle the actual balances in place at the period end. To the extent that balances change between the period end and the settlement date, an entity cannot demonstrate an intention to net settle the previous balance. (FAQ 47.28.1)

Cash pooling arrangements such as those described above can be complex; each arrangement should be viewed in light of its specific facts and circumstances. Further disclosure of gross balances might be necessary if the amount at the balance sheet date does not reflect normal cash balances throughout the year. Cash pooling arrangements are also typically disclosed as part of the offsetting financial assets and liabilities disclosures of paragraph 13A-F of IFRS 7 in the consolidated financial statements.

5.5 Investments in money market funds and similar arrangements

The standard specifically excludes equity investments from cash equivalents, unless they are, in substance, cash equivalents. This is due to the high risk of changes in capital value, despite the instruments being readily marketable and convertible into cash. An investment in shares, for example, could be classified as a cash equivalent where preference shares have been purchased with a set redemption date and a short maturity period. (MoA 7.6).

Money market funds (MMFs), also known as money market liquidity funds, are open-ended mutual funds that invest in short-term debt instruments (for example, one day to one year) such as treasury bills, certificates of deposit, bonds, government gilts and commercial paper. The IFRS IC noted in an agenda decision that some money market funds could, in substance, meet the definition of cash equivalents where the purpose is to meet short-term cash commitments, the money market fund is convertible into a known amount of cash and it is subject to an insignificant risk of changes in value. The cash amount that will be received on redemption should be known at the time of the initial investment (FAQ 7.6.1).

Treasurers should continue to monitor announcements by regulators for any changes to MMFs regulations that could impact their assessment of cash equivalents.

In the context of MMFs, IFRS 9's classification and measurement requirements can be worked through as follows.

Step 1: Is the investment in MMFs a debt or equity investment?

Under IFRS 9, the holder will classify an investment as debt or equity by assessing whether the instrument meets the definition of debt or equity for the issuer under IAS 32. Most investments in MMFs are puttable – that is, the holder can sell its holding back to the MMF in return for cash. Whilst such puttable instruments might be classified as equity by the issuer in accordance with paragraph 16A of IAS 32, they do not meet the definition of equity (see chapter 43 para 35). Consequently, most MMFs will be considered debt instruments from the holder's perspective.

Step 2a: If the investments in MMFs are debt, how should they be classified and measured under IFRS 9?

IFRS 9 requires entities to consider whether the cash flows on debt investments are solely payments of principal and interest (SPPI) and whether the business model for holding those assets is for the collection of cash flows, sale of the assets, or a combination of the two.

In most cases, cash flows of investments in MMFs will not be SPPI. Whilst the underlying investments held by the MMF might have cash flows which do represent SPPI, those investments are periodically sold by the MMF. The MMF's net asset value will not represent SPPI, because it includes gains/losses from the sale of the underlying investments. Consequently, investments in MMFs which are puttable back to the MMF are puttable at an amount which is not SPPI. Further, any interest/dividends which are receivable on the investment in MMFs do not represent SPPI, since they are also based on the net asset value of the MMF, which includes gains/losses from the sale of the underlying investments.Investments in MMFs which are not SPPI should be held at fair value through profit or loss. If the net asset value of the MMF does not include gains/losses, further analysis will be required to determine whether the cash flows of investments in that MMF are SPPI.

Many investments in MMFs are presented as cash equivalents in the statement of financial position and cash flow statement. FAQ 7.6.1 sets out when investments in MMFs can be presented as cash equivalents. Therefore, in many cases, investments in MMFs will be measured at fair value through profit or loss but presented as cash equivalents in the statement of financial position and cash flow statement.

From a disclosure perspective, the entity holding the investments in MMFs will need to ensure that these investments are disclosed as held at fair value through profit or loss in the notes to the financial statements, and it will determine the level at which they are included in the IFRS 13 fair value hierarchy disclosures. If fair value movements on the investments in MMFs are material, the entity holding those investments will need to consider how to present any fair value movements in the income statement.

Step 2b: If the investments in MMFs are equity, how should they be presented and accounted for under IFRS 9?

As noted above, there are limited circumstances in which investments in MMFs might meet the definition of investments in equity instruments. If the investment in MMFs does meet the definition of an equity investment, it will be held at fair value through profit or loss unless the holder of the investment makes an irrevocable election to designate that investment at fair value through other comprehensive income.

Treasurers should also be aware that, in many cases, money market funds will be measured at fair value, even when they are presented as cash equivalents because they are usually debt investments that do not meet the definition of solely payments of principal and interest (SPPI) (FAQ 42.5.1).

However, the difference between fair value and amortised cost for these instruments may not be material.

5.6 Cash flow statement and balance sheet presentation - including reconciliation of financing items

Bank overdrafts that are repayable on demand and that are integral to the entity's cash management can be included as a component of cash and cash equivalents in the cash flow statement (MoA 7.4). However, bank overdrafts should still be presented separately in the balance sheet, unless they meet the requirements to be offset as discussed above in the cash pooling section. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn.

The treasurer may wish to consider settling intercompany balances or sweeping accounts to avoid the need to present an overdraft position in entity or group accounts at the period end. For more details on the accounting implications please refer to the cash pooling section above.

IFRS Accounting Standards requires disclosure and reconciliation of the components making up the cash and cash equivalents' total opening and closing balances in the cash flow statement and the equivalent balance sheet line items for cash and cash equivalents. They also requires disclosure of movements in financing liabilities, showing how financing cash flows and other amounts reconcile the opening to closing balance sheet items. Treasurer input into the disclosures will be essential to ensure that cash flows arising from transactions such as derivatives are also properly reflected.

Cash flows attributable to designated hedging instruments (that is, those that are applying hedge accounting) are classified in the same manner as the transactions that are the subject of the hedge (FAQ 7.28.1). Entities may also enter into derivatives that do not meet the criteria for hedge accounting in the IFRS Accounting Standards, but that are regarded by management as acting as hedges and reducing hedge exposure. These derivatives are sometimes referred to as "economic hedges". The cash flows relating to derivatives held as economic hedges are presented in the most appropriate manner for the business. For example, an airline would normally present cash flows for the purchase of fuel derivatives as operating activities, provided that they are directly related to fuel purchases (FAQ 7.28.2).

5.7 Offsetting arrangements

5.7.1. General guidance on offsetting

A financial asset and a financial liability should be offset when, and only when, both of the following are satisfied:

- the entity currently has a legally enforceable right to offset the recognised amounts; and
- the entity intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously (MoA 47.15).

If the offset conditions are satisfied, and the entity has the right to receive or pay a single net amount and it intends to do so, it has, in effect, only a single financial asset or financial liability. In that situation, the financial asset and the financial liability are presented on the balance sheet on a net basis. If the offset conditions are not satisfied, the financial asset and the financial liability are presented separately from each other, consistently with their characteristics as the entity's resources or obligations (MoA 47.16).

5.7.2. Right of set off

A right of set-off is "*a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor*". The conditions supporting the right might vary from one legal jurisdiction to another and, therefore, the laws applicable to the relationships between the parties would need to be considered carefully. For offsetting to be applied by a reporting entity, the legal right of set-off does not have to be held by all parties to the contract, only by the reporting entity (MoA 47.18).

A debtor might have a legal right to apply an amount due from a third party against the amount due to a creditor, provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off (MoA 47.19).

An entity's right of set-off:

- must be currently available (that is, it is not contingent on a future event); and
- must be legally enforceable in all of the normal course of business, in the event of default, and in the event of insolvency or bankruptcy of the entity and all of the counterparties (MoA 47.20).

The nature and extent of the right of set-off, including any conditions attached to its exercise and whether it would remain in the event of default, insolvency or bankruptcy, might vary from one legal jurisdiction to another. It cannot therefore be assumed that the right of set-off is automatically available outside the normal course of business. For example, the bankruptcy or insolvency laws of a jurisdiction might prohibit or restrict the right of set-off in the event of bankruptcy or insolvency. Entities will therefore need to consider the laws that apply to the relationships between the parties (including the laws that govern the contract, defaults or bankruptcies), to ascertain whether the right of set-off is enforceable in the normal course of business, in the event of default, and in the event of insolvency or bankruptcy of any of the parties (including the entity itself) (MoA 47.21).

5.7.3. Intention to settle net

In order to achieve offset, an entity must have both the right to set off and the intention to do so. Although the existence of an enforceable legal right of offset affects the entity's rights and obligations associated with a financial asset and a financial liability, and might affect its exposure to credit and liquidity risk, it is not, by itself, a sufficient basis for offsetting. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of the entity's future cash flows are not affected. However, if, in addition to the legal right, the entity clearly intends to exercise the right or to settle simultaneously, it is, in effect, exposed to a net amount, which reflects the timing of the expected future cash flows and the risks to which those cash flows are exposed (MoA 47.22).

An entity's intentions with respect to settlement of particular assets and liabilities might be influenced by its normal business practices, the requirements of financial markets and other circumstances that might limit the ability to settle net or to settle simultaneously. If an entity has the right of offset, but does not intend to settle net, this will have an effect on the entity's credit risk exposure (MoA 47.23)

Realisation of a financial asset and settlement of a financial liability are treated as simultaneous only when the transactions occur at the same moment. For example, the operation of a clearing house in an organised financial market or a face-to-face exchange might facilitate simultaneous settlement of two financial instruments. In these circumstances, the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk. In other circumstances, an entity might settle two instruments by receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. Such risk exposures, though brief, might be significant, and so net presentation is not appropriate (MoA 47.24).

The entity might have a right to settle net, but it might still realise the asset and settle the liability separately (for example, where balances are cleared through clearing houses or similar settlement systems). If the entity can settle amounts in such a way that the outcome is, in effect, equivalent to net settlement, the entity will meet the second criterion of paragraph 42 of IAS 32 that the entity "intends to either settle on a net basis or to realise the asset and settle the liability simultaneously". This will occur only if the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk, and that will process receivables and payables in a single settlement process or cycle. This would then be effectively equivalent to net settlement and would satisfy the IAS 32 criterion. The standard gives an example of characteristics that a gross settlement system could have to meet a net settlement equivalent in paragraph 42(b) of IAS 32 (MoA 47.25).

An entity might enter into a 'master netting arrangement' with a counterparty with which it undertakes a number of financial instrument transactions. Such an arrangement creates a right of set-off that becomes enforceable, and it affects the realisation or settlement of individual financial assets and financial liabilities only following a specified event of default, or in other circumstances not expected to arise in the normal course of business. These arrangements are commonly used by financial institutions to provide protection against loss in the event of bankruptcy or other circumstances that result in a counterparty being unable to meet its obligations. In the event of default on, or termination of, any one contract, the agreement provides for a single net settlement of all financial instruments covered by the agreement. Such an agreement does not provide a basis for offsetting unless both of the offsetting criteria (see MoA para 47.15) are satisfied. Where financial assets and financial liabilities subject to a master netting arrangement are not offset, the effect of the arrangement on an entity's exposure to credit risk is disclosed in accordance with paragraph MoA 47.59 (MoA 47.28).

5.8 Frequently asked questions

5.8.1 Can an investment in an MMF be classified as a cash equivalent?

Illustration

Sometimes, instead of investing separately in money market instruments, an entity might invest in a money market or liquidity fund (MMF). An MMF is an open-ended mutual fund that invests in short-term debt instruments (typically one day to one year) such as treasury bills, certificates of deposit, bonds, government gilts and commercial paper. The main goals are the preservation of principal, high liquidity and a modest incremental return over short-term interest rates or a benchmark rate. Therefore, an MMF's per unit net asset value remains fairly constant over time.

Solution

MMFs can be classified as debt or equity instruments, depending on their characteristics. This classification would be made by applying the guidance in IFRS 9 (see MoA chapter 42 para 8). Entities need to assess whether MMFs meet the definition of 'cash and cash equivalents'. This is a separate assessment from the classification required under IFRS 9. The IFRS IC noted, in an agenda decision, that some MMFs could, in substance, meet the definition of cash equivalents, where the

purpose is to meet short-term cash commitments, the MMF is convertible into a known amount of cash, and it is subject to an insignificant risk of changes in value. This means that the cash amount that will be received on redemption should be known at the time of the initial investment. It is not sufficient that the instrument itself is readily convertible into cash and has a determinable market value. Instead, it means that, at the time of the initial investment, the entity is satisfied that the risk of changes in value is insignificant and that therefore the amount of cash to be received on redemption is known.

Possible approaches to such an assessment include either of the following:

Approach 1: 'Look to' the fund unit to establish whether the unit qualifies as cash and cash equivalents

Strict stated fund management policies and controls mean that the investment in the fund unit itself meets all of the criteria for classification as cash equivalents (that is, it is short term, highly liquid, readily convertible to known amounts of cash, and subject to an insignificant risk of changes in value). This usually implies that those policies have been established by a local regulator, that a process and controls exists to ensure an effective application of these policies, and affiliation to, or membership of, a money market association that ensures maintenance of high standards.

Examples of policies and controls that might be expected in combination to meet IAS 7 criteria include the following:

1. Short term and highly liquid
    a. Policies and controls to ensure that the investment is short term: The MMF investment is puttable, with no more than a short notice period;
    b. Policies and controls to ensure that the fund is able to honour redemption requests from investors, including during times of market stress: Those policies might cover matters such as minimum daily/weekly maturing assets, stress testing and 'Know your Investor' procedures. Liquidity gates designed to limit redemptions in times of market stress should be carefully assessed, but they would not necessarily preclude classification as cash and cash equivalents;
    c. Policies and controls to ensure that the investment is readily convertible to known amounts of cash and subject to insignificant risk of changes in fair value that are listed at 2 below: This reflects that a lower risk of changes in fair value indicates that it is more likely that the investment is liquid.
2. Readily convertible to known amounts of cash and subject to an insignificant risk of changes in value

    Policies and controls to ensure an insignificant risk of changes in value:

    Policies and controls to ensure a linear performance, with an objective to limit volatility to a very small percentage (typically, no greater than 0.5%), which is supported by actual performance and that suggests an insignificant risk of changes in value.

    Such policies and controls should also ensure:

    a. low credit risk exposure:
        i. For the fund, a high available credit rating for the fund if it is rated itself, when compared to a demand deposit at a banking institution in the territory in which the fund is based that would itself be cash and cash equivalents;
        ii. For the underlying assets of the funds, policies and controls to ensure that the portfolio comprises investments in high-quality (and, typically, short-term) assets and is highly diversified (that is, typically no more than 10% per issuer). In assessing credit risk, both the level of diversification of the portfolio and its weighted average life (WAL) should be considered, since the level of diversification does not address the risk of a market-wide change in the price of credit risk. The WAL measures the weighted average residual maturity of the MMF's portfolio and is a measure of its credit and liquidity risk. The higher the WAL, the higher the exposure to both credit and liquidity risk, because there is a longer period of time before both the returns on the MMF's assets are adjusted to current credit spreads and the assets held by the MMF mature.

b. low interest rate risk exposure:

   i. A return benchmarked to short-term money market interest rates;

   ii. The weighted average maturity (WAM) measures the weighted average period until the next repricing of the assets held by the fund. It is used to assess the sensitivity of the assets to changes in the benchmark interest rate. The higher the WAM, the higher the exposure to benchmark interest rate risk, because there is a longer period of time before the assets held by the MMF reprice to current benchmark interest rates. Investments that have a WAM higher than 90 days would be presumed to fail this criterion.

Taking into account all of the considerations above, the definition of a cash equivalent might be met.

Approach 2: 'Look through' the fund to establish whether substantially all of its investments qualify individually as cash and cash equivalents

This approach is only acceptable for funds that contain a put option exercisable with a short notice period, and it should cover all potential investments allowed by the investment rules set for the fund, and not only the assets that the fund holds as of the evaluation date. Investments whose maturity is more than three months typically do not qualify individually as cash and cash equivalents.

Whichever of the two approaches is used, where a third party, such as an MMF institution, has suggested a classification for a particular MMF category, the entity should assess that suggestion against the definition of cash and cash equivalents and the guidance above.

Entities should also confirm the classification of MMFs at each reporting date. (FAQ 7.6.1)

5.8.2 Is cash deposited in a group treasury function cash or a cash equivalent?

The cash deposited with group treasury should firstly be assessed to determine whether it qualifies as a demand deposit and is cash. Demand deposits are not restricted to deposits with financial institutions or banks.

However, it is very unlikely that amounts deposited in a group treasury function would qualify as a demand deposit. This is because the treasury function and the related subsidiary are controlled by the parent, meaning any demand feature could typically be removed at any point by the parent. Consequently, amounts deposited within a group treasury function will rarely qualify as a demand deposit.

If it is determined that the cash deposited with group treasury is not cash, entities should assess if the cash deposited meets the definition of 'cash equivalents'. We expect that balances within a group treasury function would qualify as 'cash equivalents' only in limited circumstances.

'Cash equivalents' must be 'subject to an insignificant risk of changes in value'. Banking institutions are subject to capital requirements, regulatory oversight, third party liquidity management, and are generally independent of deposit makers. However, there are no regulatory restrictions on group treasury functions within companies to maintain a cash or capital balance sufficient to meet the demand obligation that attaches to inter-company balances. The creditworthiness of the group treasury function can fluctuate depending on decisions it (or the group) might make. Also, unlike a financial institution whose liabilities are backed by a diverse portfolio of income yielding assets, liabilities of a treasury subsidiary might be backed principally by receivables from other group subsidiaries, and hence the creditworthiness of the group treasury function is highly dependent on the commercial performance of these businesses.

Factors that could indicate that balances within a group treasury function are subject to an insignificant risk of changes in value include the following:

- the group treasury function maintains sufficient cash and liquid resources, along with access to credit lines, to meet all inter-company obligations simultaneously;

- adequate controls and procedures of the group treasury function exist, for example, similar to those that a regulated financial institution would be subject to;
- demonstration that the group treasury function is continuously monitored and managed to maintain the liquidity position of the group as a whole;
- review of the group treasury controls and procedures by the board of directors, including but not limited to review of the group's credit risk, continuous maintenance of a specified cash coverage ratio and the parent's liquidity position; and
- monitoring the liquidity exposure of the group respective to the credit risk of various subsidiaries with open receivable positions.

If the above factors are met, the company might be able to demonstrate that these balances within a group treasury function are subject to an insignificant risk of changes in value, thereby meeting the definition of 'cash equivalents'. This might be considered a significant accounting judgement, the nature of which should be disclosed. Entities should also consider the requirements for related party disclosures and financial risk management as it pertains to the group treasury function. (FAQ 7.3.7)

6. Trade finance

Working capital optimisation

A key part of a treasurer's daily activities is to optimise working capital and ensure sufficient access to cash. Some of the more common strategies to either advance the receipt of cash from debtors or delay payments to suppliers are the factoring of receivables and supplier finance (also known as reverse factoring) arrangements. Apart from improving their immediate cash position, entities often strive to also improve their financial ratios by achieving a desired accounting outcome from the arrangement, most often by removing (that is, "de-recognising") the factored receivables from their balance sheets or by keeping trade payables subject to supplier finance arrangements presented within the "trade and other payables" line item on the balance sheet.

It is important for treasurers to understand the complexities associated with accounting for these transactions, as the accounting treatment should reflect the substance (i.e. financing), which might not be reflected by the legal form. This may have unintended or unexpected consequences on financial ratios, which may in turn have a negative impact on debt covenants or performance measures.

6.1 Factoring arrangements

Factoring is a well-established method of obtaining finance based on the value and the quality of an entity's trade receivables without having to enter into a bank borrowing. In addition, it could also allow an entity to obtain sales ledger administration services or protection from bad debts.

A factoring transaction involves a transferor ("the seller") transferring its rights to some or all of the cash to be collected from a financial asset (usually trade receivables) to a third party ("the factor") in exchange for an upfront discounted cash payment. In practice, factoring can be achieved in many forms. Key features of typical factoring transactions are:

- The cash payment - this can be fixed at the outset, or it can vary according to the actual period for which the receivables remain unpaid (whereby the seller retains the late payment risk). The factor might even provide a credit facility that allows the seller to draw amounts up to a fixed percentage of the face value of the receivables transferred.
- The nature of the agreement - this might be a legal sale of the underlying receivable, or the acceptance of an obligation to remit any funds collected from a receivable to a factor. In addition, it could be a transfer without any recourse to the seller in the event of non-payment by the debtor, or it might be more complex with various recourse or subordination provisions.

- Other provisions - these might include, amongst others, any representations or warranties provided by the transferor regarding the receivables' quality/condition at the point of transfer; servicing arrangements (whether the transferor will continue to manage the receivables or management will be taken over by the factor); refunds for credit notes issued by the seller; or any credit protection facility (such as insurance cover) provided by the factor that might limit the extent to which the factor has recourse to the seller (EX 44.61.3).

6.1.1 General overview

Factoring can be achieved in many forms, ranging from a legal sale of the underlying receivable to accepting an obligation to remit any funds collected on a receivable to a factor.

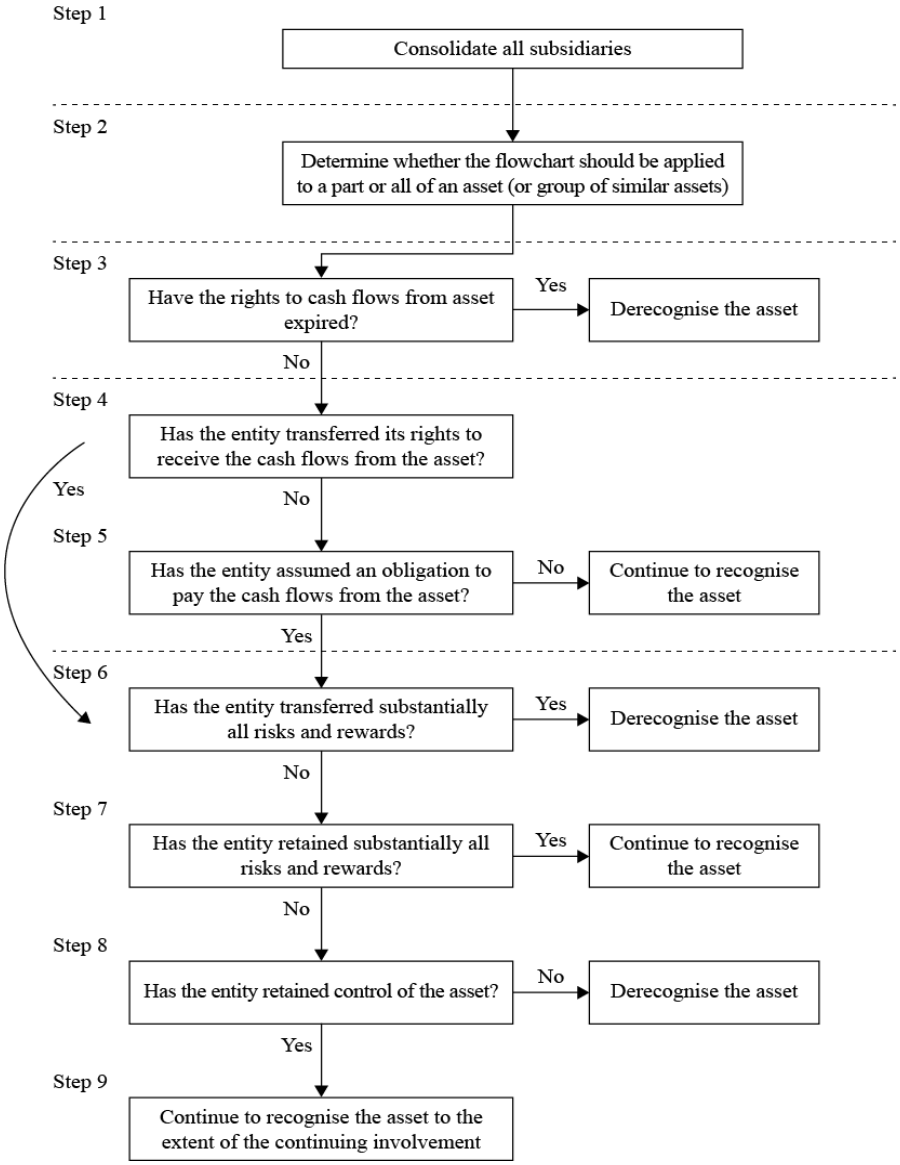
In assessing the accounting treatment to be applied to a factoring arrangement, the key consideration is whether the factored receivables may be removed from the balance sheet (that is, de-recognised), or whether the transaction should be accounted for as financing arrangement.

PwC insight

Even if an entity transfers all of its contractual rights to a receivable to another party (for example, under a "legal sale" agreement), in many instances, the accounting treatment may not reflect an outright sale. A careful analysis will be required to conclude on the accounting, especially where there are risks retained by the transferor (for example, by providing the factor with a guarantee in the event of non-payment by a debtor or through retaining some or all of the late payment, interest rate or foreign currency risks). Since the accounting treatment is dependent on a careful analysis of the contractual provisions as well as the facts and circumstances surrounding each transaction, we would recommend consulting with professional advisers before concluding a factoring arrangement.

IFRS 9 sets out the requirements to be considered regarding the derecognition of all financial assets, from the simple maturity of an instrument to the more complex securitisation transactions. The standard provides a flow chart that summarises these requirements for evaluating whether, and to what extent, a financial asset is de-recognised. Every transaction should be analysed using the strict sequence set out in the flow chart. There are two separate approaches to derecognition under IFRS Accounting Standards: the 'risks and rewards' approach and the 'control' approach. The control approach is only used where the risks and rewards approach does not provide a clear answer and the control approach is often only helpful for liquid traded instruments (MoA 44.22).

The sequence to be followed in a de-recognition analysis is summarised below:



Consider the level of assessment

The first step in the analysis is to determine the level of the assessment - that is, whether the separate financial statements of the transferor, or the consolidated financial statements of the group are being considered.

PwC insight

Many entities establish structured entities to acquire financial assets before these financial assets are transferred to a third party. The transfer of financial assets to such an entity might qualify as a legal sale. However, if the substance of the relationship between the transferor and the structured entity indicates that the transferor controls the structured entity, the transferor should consolidate the structured entity, which might result in the transferred assets remaining on its balance sheet.

Consider the financial asset subject to the assessment

The second step requires an entity to consider whether the analysis should be applied to a part of a financial asset or to a financial asset in its entirety. The de-recognition rules should be applied to a part of a financial asset if, and only if, the part being considered for derecognition meets one of the following conditions:

- the part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets);
- the part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets); or
- the part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets) (MoA 44.24).

PwC insight
In some instances, an entity might contractually agree to sell a proportion of a cash flow to a factor, but if the transferor and factor do not share proportionately in the cash flows recovered from the debtor, the de-recognition analysis should be performed on the receivable in its entirety, and not only on the proportion as indicated in the contract.
When considering the proportionate sale of a cash flow, it is also important to consider the legal framework applicable to such transactions. In certain jurisdictions, a proportionate sale might be prohibited unless the debtor is informed of and agrees to the proportionate sale of the cash flow due.

In some instances, an entity might have already obtained credit insurance for a portfolio of receivables prior to factoring them. If, on factoring, the factor becomes the beneficiary of the credit insurance, the question arises as to what is the 'asset' for the purpose of the de-recognition criteria. Is it only the receivables, or is it the receivables plus the credit insurance? In the absence of guidance within IFRS 9, the term 'asset' can be interpreted to mean either:

- all related contracts, including purchased options, swaps and insurance contracts transferred with the loans/receivables in a single transaction that share and mitigate some of the risks on the loans because those are the cash flows that will be paid to the factor; or
- only the transferred loans/receivables themselves.

An entity must choose one of these two approaches as its accounting policy and apply it consistently. When performing a risks and rewards analysis, the net cash flows of the transferred asset should be determined consistently with the policy chosen for determining the original asset (FAQ 44.30.3).

PwC insight

When the contractual rights to the receivables are transferred together with related credit insurance, considering the 'asset' as only the transferred receivables is more likely to result in de-recognition. This is because the asset is viewed as uninsured receivables that are likely to have significant credit risk. Since this credit risk is transferred to the factor, it is more likely that the transaction will pass the risks and rewards test. If the asset is viewed as credit insured receivables, they are likely to have lower credit risk. Therefore, any risk retained by the seller (other than that covered by the credit insurance) will be relatively more significant. (Refer to the discussion on considering the risks retained later on in this chapter) (EX 44.61.3).It should be noted that there is a separate question as to whether the credit insurance contract has been transferred, and the answer to that will depend on the facts and circumstances.

Once it has been established whether the whole asset (or a group of similar assets) or a qualifying portion is considered for derecognition, the remaining steps of the flow chart should be applied to that whole or part identified.

Consider whether 'transfer' is achieved

If the contractual rights to the cash flows have not expired (that is, the debtor has not yet settled its obligation), an entity should assess whether it has transferred the cash flows from the asset. Transfer can be achieved only if one of two conditions is met:

- the entity transfers the contractual rights to receive the financial asset's cash flows (that is, akin to a sale); or
- the entity retains the contractual rights to receive the financial asset's cash flows, but it assumes a contractual obligation to pay the cash flows to one or more recipients. This is often referred to as a 'pass-through arrangement' (MoA 44.28).

If the transfer is in the form of a pass-through arrangement, then additional requirements need to be satisfied in order to progress to the risk and rewards analysis (refer to IFRS 9 par.3.2.5). The pass-through test is in practice often very difficult to meet.

PwC insight

It is important to consider the legal terms in the factoring agreement in determining whether transfer has indeed been achieved and more specifically, which type of transfer. Depending on the complexity of the arrangement, specialist advice might be required to conclude on the type of transfer achieved.

'Risks and rewards' assessment

Once an entity has established that it has transferred a financial asset, either by transferring the contractual rights to receive the cash flows or under a qualifying pass-through arrangement (refer to IFRS 9 para 3.2.5), it carries out the risks and rewards test. This test requires the entity to evaluate whether it has:

- transferred substantially all of the financial asset's risks and rewards of ownership;
- retained substantially all of the risks and rewards of ownership; or
- neither transferred nor retained substantially all of the risks and rewards of ownership (MoA 44.33).

PwC insight

Risk considerations
The risks and rewards test normally considers any recourse provisions, such as credit risk via guarantees, put options and late payment risk, interest rate or currency risk retained.
In practice, credit risk is most often one of the key risks that a transferor remains exposed to after a transfer. Credit risk is often retained in circumstances where the transferor would be obliged to make payments to the factor in certain default events. Alternatively, the transferor might be obliged to repurchase receivables sold under certain circumstances. These recourse provisions might take the form of:

- guarantees by the seller for non-payment (that is, the seller retains bad debt/credit risk), up to a certain limit or the full default amount;
- a call option by the transferor (for example, to repurchase defaulted receivables);
- a put option by the factor for any defaulted assets; or
- the seller agreeing to pay interest to the buyer for any overdue receivables (that is, the seller retains late payment risk) (EX 44.61.3).

The standard requires this evaluation to be performed by comparing the entity's exposure to the variability in the amount and timing of the net cash flows of the transferred asset before and after the transfer. It is therefore important to note that in some instances, this assessment could be complex because the test is based on a relative and not an absolute risk comparison. While a qualitative assessment would often be sufficient, in more complex situations assistance of a specialist might therefore be required to model an entity's exposure to the variability in the cash flows of the asset before and after the transfer based on different scenarios.

Warranties and credit notes

In our view, provided that the entity has fully performed its obligations to its customers, warranties to enable customers to return faulty goods and credit notes given for volume discount should not be considered in the risks and rewards analysis where an entity has transferred its contractual rights to a receivable to a factor. This is because warranties relate to the asset's condition at the date of sale and to whether a valid receivable exists, rather than to risks and benefits in relation to its future performance.

In some cases, the recourse provisions result in the transferor retaining substantially all the risks and rewards of ownership of the receivables, with the effect that the entity continues to recognise the factored receivables. In other cases, the recourse provisions result in the transferor retaining some, but not substantially all, of the risks and rewards, in which case the control test must be considered.

'Control' assessment

If an entity determines that it neither retained nor transferred substantially all of the risks and rewards, the entity should perform a control analysis to ascertain which party has control of the asset (MoA 44.41). Control, in this context, is based on whether the factor has the practical ability to sell the transferred asset in its entirety to an unrelated third party, and whether it is able to exercise that ability unilaterally and without imposing additional restrictions (MoA 44.44). In many factoring arrangements that are subject to recourse, the transferee is precluded from selling the receivables, which means that the transferor continues to 'control' them.

If an entity determines that it retained control, it needs to continue accounting for the transferred asset to the extent of its continuing exposure to the risks and rewards of the asset (MoA 44.41).

PwC insight

Quantifying the extent of an entity's continuing exposure to the risks and rewards of an asset is often complex and the assistance of a specialist might be required. Furthermore, an entity might retain the right or obligation to service the assets transferred (for example, send out statements, administrate payments received and execute recovery activities), either for a fee or no compensation. IFRS 9 requires an entity to consider the adequacy of the compensation and to raise either

a. "servicing asset" if the fee to be received is expected to be more than adequate compensation for the servicing, or

b. "servicing liability" if the fee is not expected to adequately compensate the entity for performing the service (MoA 44.78).

6.1.2 Frequently asked questions

6.1.2.1 Does an entity retain any risks and rewards of ownership if it factors receivables without assuming any recourse due to the late payment or non-payment of the receivables?

In a non-recourse factoring arrangement, the transferor does not provide any guarantee about the receivables' performance. In other words, the transferor assumes no obligations whatsoever to repay any sums received from the factor regardless of the timing or the level of collections from the underlying receivables. In such a situation, the entity has transferred substantially all of the risks and rewards of ownership of the receivables and de-recognises the receivables in their entirety. (FAQ 44.61.3)

6.1.2.2 How should an entity consider its exposure to the risks and rewards of ownership if it factors receivables whilst retaining limited recourse associated with non-payment of the receivables?

Illustration

Entity A sells a portfolio of receivables to a factor. The receivables have a face value of CU 100 million. Entity A assumes an obligation to reimburse the factor for the first CU 10 million of losses arising from non-payment (that is, 10% of the face value of the portfolio). The factor therefore assumes the credit risk associated with any losses exceeding CU 10 million. The average historical loss on similar receivables amounts to 2%, with a maximum historical loss of 4%. The loss experience is expected to continue for the duration of the arrangement.

For the purposes of this example, assume that:

- credit risk is the most significant risk;
- all other relevant risks (for example, late payment risk) are insignificant; and
- the underlying receivables are not subject to credit insurance.

Accordingly, the entity will only consider the impact of credit risk in assessing the extent of the risk transfer.

Entity A considers that before the sale, it was exposed to potential losses of up to CU 100 million whereas, after the sale, it is only exposed to losses of up to CU 10 million. Can entity A therefore conclude that it has transferred substantially all of the risks and rewards of ownership and therefore derecognise the receivables?

Solution

No. IFRS 9 requires the risks and rewards analysis to be performed by comparing the entity's exposure to the variability in the amount and timing of the net cash flows of the transferred asset before and after the transfer. The assessment should therefore be based on a relative, and not an absolute basis.

Even though entity A has reduced its maximum exposure to credit risk by 90%, the likelihood of losses, and therefore the extent of its expected exposure prior to the sale, only amounted to a maximum of 4% of the portfolio's face value. Consequently, since entity A will have to reimburse the factor for any losses of up to 10% of the portfolio's face value after the sale, it retains substantially the same exposure to the variability in the amount and timing of the cash flows (that is, the variability up to a likely maximum of 4%, assuming that historical loss trends are unchanged in future) after the sale.

Entity A therefore retains substantially all of the risks and rewards of ownership of the receivables and should continue to recognise the factored receivables.

In other cases, it might not be as obvious whether the entity transferred or retained the variability in the timing and amount of the cash flows from a financial asset and a more complex computation would be required. (FAQ 44.40.1).

6.1.2.3 How should an entity account for the factoring of payments not yet due?

In some transactions, the contract requires the customer to pay part or all of the consideration before the entity provides any goods or services. The entity might factor the rights to these future cash flows before the goods or services have been provided and the related receivable recognised. For example, an entity might factor a future operating lease receivable. If an entity factors such unrecognised receivables, the entity should recognise the factoring arrangement as financing (that is, it should recognise a liability for the amounts received from the factor), because there is no asset to de-recognise.

Consider a five-year maintenance contract, with payments to be billed annually in advance, or an operating lease contract with rentals due quarterly in advance. The entity has a contractual right to receive cash from the date when the contract is signed, even though it has provided no goods or services at that time. Such contracts give rise to the question of when a financial asset for the amounts due under the contract should be recognised. No asset should be recognised until at least one of the parties has performed under the contract.

Such an arrangement comprises two elements. The first element is the sale of goods or services, which is an executory contract and hence is not recognised until the goods or services are delivered. The second element is a loan commitment (being the agreement by the customer to pay in advance). The second element is outside the scope of IFRS 9. Hence, no financial asset is recognised for either of the elements prior to performance or draw-down of the upfront payment.

If the entity factors the future cash inflows before recognising the receivable (for example, before the goods and services have been delivered), the entity should recognise a financial liability for the amounts received from the factor. (EX 44.61.3)

6.1.2.4 What should an entity consider when assessing the transfer of risks and rewards where it retains late payment risk?

Illustration

Entity A transfers a portfolio of trade receivables to a factor. The factor assumes the default risk of the transferred receivables. Entity A retains the late payment risk by paying interest on overdue amounts to the factor, based on SOFR plus a margin. The trade receivables transferred have a history of no defaults and no late payment since the start of the business relationship between entity A and the customers.

Solution

The risks and rewards test should compare on a relative, and not an absolute, basis:

- Entity A's retained risks and rewards after the transfer (this is the variability due to late payment risk); and
- The total risks and rewards associated with the financial asset before the transfer (this should consider both the risk of default and the risk of late payment).

The lack of observed defaults and late payments does not justify an assumption that there are no risks attached to the receivables transferred to the factor. In the absence of any observable data, the risks and rewards test should be performed by looking at both qualitative and quantitative factors. The objective is to gain insight into the economics of the default and the late payment risks, in order to be able to assess their relative significance.

Qualitative questions to be addressed could include:

- How are late payment and default risk managed by entity A? The amount of resources that entity A devotes to managing a risk might indicate the relative importance that it attaches to that risk.
- If the factor is, in general, unwilling to assume late payment risk, why is this?
- If the factor is willing to assume the late payment risk as well as the default risk that it has actually assumed, what price would/does it charge?

Quantitative aspects include using index information of peers or industries to approximate the default risk and the late payment risk inherent in the portfolio of receivables transferred to the factor.

If this information does not make the result of the risks and rewards analysis clear, it might be necessary to build a model that encompasses all of the data and information gathered (that is, a numerical computation of risks and rewards). The modelling of risks and rewards is complex and will be subject to simplifications and assumptions.

To the extent that the qualitative factors indicate that a significant risk has been retained, the entity should be able to demonstrate objectively that the late payment risk is not significant in order to achieve derecognition. Such a quantitative analysis should use data that is relevant to the receivables being factored. (FAQ 44.40.1)

6.2 Supplier financing and reverse factoring

Supplier finance arrangements are an example of an agreement between a company (as the buyer), its supplier and a bank (or other finance provider) that can serve several purposes:

1. to extend the buyer's payment terms, by having a payment date to the bank later than the original due date of the invoice;
2. for the bank to act as the buyer's paying agent, and to pay the buyer's suppliers on its behalf on the date when the payables are due;
3. to provide liquidity to the buyer's suppliers seeking payment before the due date.

Judgement and careful analysis of terms and conditions will often be needed when accounting for supplier financing arrangements.

PwC insight

Investors want to understand the size and key terms of supplier finance arrangements.

Starting in 2024, IFRS Accounting Standards reporters will be required to provide additional disclosures about these arrangements in order to fulfil those investor needs.

6.2.1 Scope

What is a supplier finance arrangement?

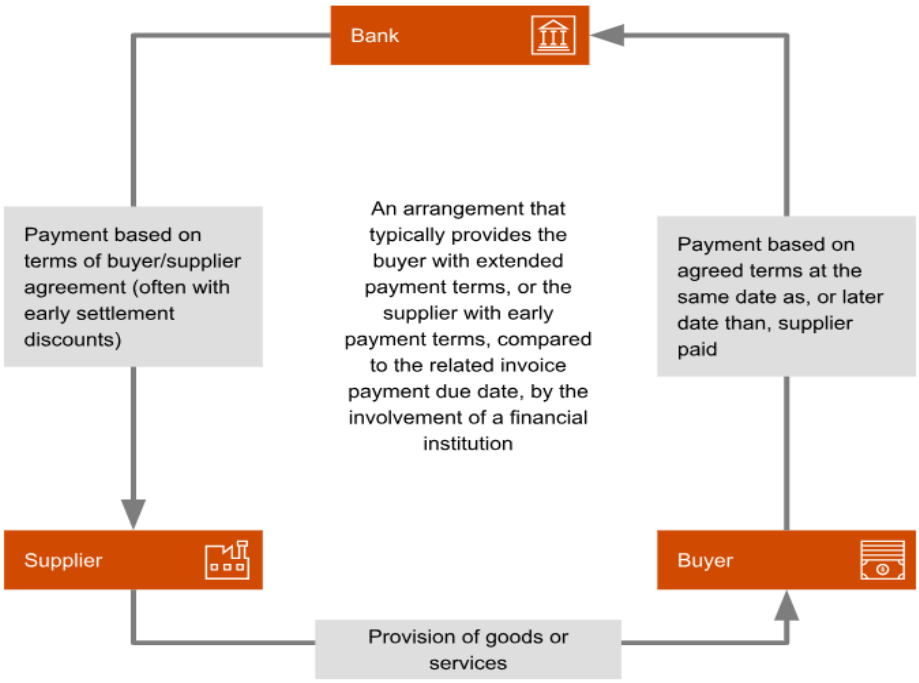
Supplier finance arrangements often go by a number of names, including 'reverse factoring', 'supply chain finance' or 'payables finance'. A supplier finance arrangement is identified through its characteristics, rather than how it is labelled. A key characteristic is that three parties (that is, a buyer, a supplier and a finance provider) are interacting to achieve a financing objective for at least one of the parties.

In many cases, it will be clear with little analysis whether an arrangement is supplier finance.

For the purpose of the specific supplier finance disclosure requirements (see section 6.2.6), IFRS Accounting Standards explain that:

"*Supplier finance arrangements are characterised by one or more finance providers offering to pay amounts an entity owes its suppliers and the entity agreeing to pay according to the terms and conditions of the arrangements at the same date as, or a date later than, suppliers are paid. These arrangements provide the entity with extended payment terms, or the entity's suppliers with early payment terms, compared to the related invoice payment due date*."

Key steps in a supplier finance arrangement:



A typical supplier finance arrangement will often include most or all of the following steps:

1. The supplier delivers goods to the buyer, creating a trade payable for the buyer and a trade receivable for the supplier.
2. The buyer confirms the trade payable - that is, it confirms the amount, the due date, and the fact that the goods have been delivered and/or that it will pay the trade payable by the date agreed with the finance provider (depending on the arrangement in place, this might be by the due date or later).
3. The supplier's trade receivable is assigned or novated to the bank, in exchange for the buyer committing to pay the bank.
4. The supplier receives payment from the bank, either at the original due date or earlier.
5. The buyer pays the bank, typically on or after the due date of the invoice.

What is not a supplier finance arrangement?

Some other types of financing might have some similar characteristics to supplier finance arrangements, but not all of the characteristics. For the purpose of the reporting requirements the following are examples of arrangements that are not supplier finance arrangements for the buyer:

1. Arrangements that finance an entity's receivable or inventory. One of the key characteristics of supplier finance arrangements is that they finance 'amounts an entity owes its suppliers'.
2. Arrangements that are solely credit enhancements for the buyer, or instruments used by the buyer to settle directly with a supplier the amounts owed, such as:
   a. Financial guarantees, including letters of credit used as guarantees.
   b. Credit cards used to directly settle the amount owed to a supplier.
3. Some commodity intermediation agreements under which a financial institution purchases and obtains control of commodities and sells those commodities as a principal to a company as needed.

PwC insight

While analysing whether an arrangement is a supplier finance arrangement, it might be helpful to keep the following points in mind:

- The reporting requirements in this section are for the buyer (although there are typically three parties involved in these arrangements, including the buyer).
- Arrangements under which the buyer does not have a liability are not supplier finance arrangements.
- The arrangement has a financing purpose either for the buyer or the supplier.

The IASB had extensive discussions about the scope of the disclosures requirements for supplier finance arrangements. It decided to confine the scope to arrangements that finance amounts an entity owes its suppliers, and therefore concluded that an entity is not required to identify other actions its suppliers might have taken to finance their receivables (for example, factoring of receivables).

Paragraphs 31- 33 of the Basis for Conclusions on IAS 7 provide further information on the IASB's rationale.

6.2.2 Recognition and derecognition

Recognition of a trade payable

The buyer recognises a trade payable liability when goods or services are purchased from the supplier.

Derecognition of the trade payable

IFRS 9 derecognition requirements apply to trade payables. When applying those requirements to trade payables included in supplier finance arrangements, careful consideration of all of the terms and conditions is required. Typically, one of the key questions is whether the buyer:

- continues to recognise that trade payable liability up until the point in time when the buyer pays the bank; or instead
- derecognises the trade payable liability, and replaces it with a new liability, when that trade payable becomes part of a supplier finance arrangement.

See below for guidance on presentation in the statement of financial position.

Applying IFRS 9, a financial liability (trading or other) is derecognised when it is extinguished (that is, when the obligation is discharged, is cancelled or expires).

A financial liability (or part of it) is extinguished when the debtor either:

- discharges the liability (or part of it) by paying the creditor (normally with cash, other financial assets, goods or services); or
- is legally released from primary responsibility for the liability (or part of it), either by process of law or by the creditor.

In addition, a substantial modification of the terms of an existing financial liability (or part of it) is an extinguishment of the original financial liability and recognition of a new financial liability.

As such, the buyer in a supplier finance arrangement needs to assess whether the arrangement has substantially modified the trade payable, such that it should be considered as a new arrangement.

The following list of questions and indicators is not exhaustive, but it will aid in the assessment of whether the supplier financing arrangement results in the derecognition of the trade payables in accordance with IFRS 9.

The answers to the questions, as well as any other indicators that the nature of the trade payable has changed, need to be considered together to gain an understanding of the substance of the arrangement and whether the original trade payable should be derecognised or not.

While the analysis should consider the indicators in totality, some indicators might carry more weight than others – for example, the inclusion of jointly and severally liable or cross-default clauses or guarantees is an important indicator that the original trade payable should be derecognised.

Questions	Indicators of derecognition (bank finance)	Indicators of no derecognition (trade payable remains)
Has the invoice been assigned or novated to the bank? The terms 'novation' and 'assignment' might not have the same legal interpretation in all jurisdictions, and so the specific terms of the agreement should be reviewed and legal advice obtained if necessary.	'Novation' of invoice. If the mechanism for the transaction results in a new instrument being created which replaces the original invoice, the other indicators are not relevant and the original liability should be derecognised, since it has been legally extinguished.	'Assignment' of invoice.
What is the purpose of the introduction of supplier finance?	To improve the buyer's working capital.	To assist the supplier in obtaining affordable credit.
Has the supplier finance arrangement been introduced in conjunction with a change in payment terms such as a change in dates?	Yes, especially if: 1. terms do not change for those suppliers who are not part of the scheme, or they change back if a supplier leaves the scheme; 2. following introduction of the arrangement, the date when the buyer pays the bank is later than the date of the original invoice; 3. the revised payment terms are outside of industry/sector norms; or 4. the payment terms will revert to the previous terms when the arrangement ends.	No. If there is no change to payment terms or there is evidence that increased payments terms were already being negotiated, the new terms are within industry/sector norms and/or terms will change for all suppliers irrespective of whether supplier financing is utilised.
Who negotiates the terms of the supplier finance arrangement?	The buyer selects which suppliers should be part of the scheme, and it negotiates interest rates and terms on their behalf.	The buyer is merely acting as an agent, introducing key suppliers on criteria set by the bank, and the terms of the supplier finance (such as discount rates) are negotiated between the supplier and the bank.

Questions	Indicators of derecognition (bank finance)	Indicators of no derecognition (trade payable remains)
Does the buyer receive any fees or other payments from the bank, or make any payments to the bank other than payment of the original invoice under its terms?	Yes, if the buyer pays or receives a fee linked to the amount that the supplier factors with the banks, receives an early payment discount despite not itself paying early, or pays all or part of the interest cost under the arrangement.	No, if all fees and interest costs are borne by the supplier, or the only fee paid by the buyer is a processing fee per invoice for using the bank's platform.
Has the parent or another group entity entered into joint and several liability, a cross-default clause or a guarantee over a subsidiary's payables in conjunction with the supplier finance arrangement? Such a clause might apply in the ordinary course of business or on a change of control.	Yes. These types of clauses are not typically present in trade payable arrangements and, in such circumstances, they indicate that the nature of the liability has changed, because the bank is receiving greater surety than an ordinary supplier unless such a clause already existed.	No. If such a clause already existed (or was being negotiated separately from the supplier financing arrangement) in respect of that particular supplier (usually due to the materiality of specific purchases or credit concerns over a particular subsidiary), the inclusion of a similar credit enhancement in the supplier finance arrangement with the bank would not, in itself, indicate a change in the nature of the liability.
Is there, in substance or in practice, a tripartite agreement between the supplier, buyer and bank?	If the supplier is required to enter into the arrangement with the bank and transfer or sell all of its receivables/invoices in advance of the maturity date, there is one contract in place, which is an indicator of derecognition.	If the supplier has the choice, but not the obligation, to sell its receivables in advance of the maturity date, it is not a tripartite agreement, and it is not an indicator of derecognition.
Will the arrangement affect the timing of cash flows of the buyer with respect to the timing of payment, recognition of early payment discounts, treatment of credit notes and payment of late interest?	Yes, if payment patterns before and after the introduction of the arrangement are significantly different, or if they are significantly different from similar invoices not included within the supplier finance arrangement.	No, if payment patterns before and after the introduction of the arrangement are not significantly different.
Does the buyer have the option to determine when to pay?	No.	Yes, even though late payment penalties might be triggered (for example, interest might be incurred but would typically be less than penalties for late payment of bank loans).

Questions	Indicators of derecognition (bank finance)	Indicators of no derecognition (trade payable remains)
Does the arrangement provide the bank with the right to draw on the buyer's existing bank accounts in the event of non-payment?	Yes.	No.
Is there acceleration of payment on specified events of default?	Yes, if the arrangement states that, on specified events of default (such as a default on other trade payables, or on other bank or debt agreements), all trade payables in the programme become immediately due.	No.
Does the arrangement count towards the utilisation of a line of credit that the buyer has in place with the bank?	Yes, if the arrangement is undertaken with a bank that has already provided loans or credit/overdraft facilities and this becomes part of, rather than an extension to, those facilities.	No.

If the buyer derecognises a trade payable and recognises a new financial liability, the possible effects on the cash flow statement need to be carefully considered as mentioned in section 6.2.5 below.

6.2.3 Measurement

If the buyer derecognises its original liability (the trade payable) and recognises a new liability with the bank (see below), it will recognise:

- the new financial liability at fair value; and
- a gain or loss, based on the difference between the carrying amount of the original liability and the fair value of the new liability.

6.2.4 Presentation - statement of financial position

IAS 1 sets out how to present liabilities in the statement of financial position.

Given that 'trade and other payables' are sufficiently different in nature or function from other liabilities, paragraph 54 of IAS 1 requires these payables to be presented separately from other financial liabilities. Additional line items or disaggregation of existing line items in the statement of financial position are required, if such presentation is relevant to the understanding of the entity's financial position.

The buyer in a supplier finance arrangement needs to determine where to present a liability that is a part of a supplier finance arrangement.

No derecognition applying IFRS 9

If the liability to the supplier is not derecognised, the liability might be presented:

- within trade and other payables;
- within bank liabilities, borrowings or a similarly described line item; or

- as a line item separate from other items.

In 2020, the IFRS Interpretations Committee (the 'Committee') published an **agenda decision** on the presentation of a liability that is part of a supplier finance arrangement. The agenda decision explained that an entity presents a financial liability as a trade payable only when the liability:

- represents a liability to pay for goods or services;
- is invoiced or formally agreed with the supplier; and
- is part of the working capital used in the entity's normal operating cycle.

As such, liabilities that are part of a supplier finance arrangement:

- can be presented as part of 'trade and other payables' only where those liabilities have a similar nature and function to trade payables (for example, where those liabilities are part of the working capital used in the entity's normal operating cycle); and
- must be presented separately when the size, nature or function of those liabilities makes separate presentation relevant to the understanding of an entity's financial position.

Whilst the table in section 6.2.2 above is about factors to consider when assessing whether derecognition is required, those factors might also be helpful to consider when determining whether the nature or function of the liability warrants separate presentation even if the trade payable is not derecognised.

Derecognition applying IFRS 9

If the original liability to the supplier has been derecognised (see section 6.2.2 above), and replaced with a new liability to the bank, the presentation considerations set out under 'No derecognition applying IFRS 9' above are also relevant. However, in our view, the nature of a new liability with a new counterparty (representing a finance provider) is typically sufficiently different from a trade payable to require presentation within bank financing (or similarly described line item) or a separate line item.

6.2.5 Presentation - cash flow statement

The buyer in a supplier finance arrangement needs to carefully consider the presentation of the cash flows from these transactions in the statement of cash flows. This is an important consideration whatever the impact on the statement of financial position.

The 2020 Committee agenda decision noted that the entity's assessment of the nature of the liabilities that are part of the arrangement might help in determining whether the related cash flows arise from operating or financing activities. For example, if the entity considers the related liability to be a trade or other payable that is part of the working capital used in the entity's principal revenue-producing activities, the entity presents cash outflows to settle the liability as arising from operating activities in its statement of cash flows. In contrast, if the entity considers that the related liability is not a trade or other payable because the liability represents borrowings of the entity, the entity presents cash outflows to settle the liability
as arising from financing activities in its statement of cash flows.

Is there a cash flow for the buyer when the bank pays the supplier?

The first assessment is whether there is a cash flow for the buyer when the bank pays the supplier.

If a cash inflow and cash outflow occurred for a buyer when an invoice is factored as part of a supplier financing arrangement, the buyer presents those cash flows in its statement of cash flows.

However, IAS 7 does not provide explicit guidance on how an entity determines whether a cash flow occurred for the buyer in circumstances that another party makes a payment on the entity's behalf.

Cash flows are generally seen as movements in the entity's bank account. However this might not always be the case. An entity might incur a cash flow even though the cash does not flow through the entity's bank account (for example, when an entity directs another party to transfer the cash on its behalf).

In the case of a supplier financing arrangement, judgement will need to be exercised when making this assessment.

A cash flow has occurred for the buyer when the bank pays the supplier

In some circumstances, the buyer might judge that at the point in time when the bank pays the supplier, the buyer has effectively incurred an operating cash outflow and a financing cash inflow. The rationale is that this is appropriate because the bank, in substance, is considered to be acting as a payment agent on behalf of the buyer.

When the buyer then subsequently makes the payment to the bank, the cash flow is presented as a financing cash outflow.

A cash flow has not occurred for the buyer when the bank pays the supplier

In other circumstances, the buyer might judge that it is not a party to the cash flow between the bank and the supplier. In this case, the only cash flow that will be presented in the buyer's cash flow statement is the cash outflow when the buyer pays the bank.

This might be presented as either a financing cash outflow or an operating cash outflow.

The judgement applied to determine the classification of cash flows should be clearly disclosed, if material, following IAS 1 requirements (see next section).

PwC insight

When considering the classification and presentation of supplier finance arrangements in the statement of financial position and cash flow statement, entities should also consider the views of securities regulators in their respective jurisdictions.

For example, we understand that the US SEC staff's view is that if the economic substance of the trade payable has changed as a result of a supplier finance arrangement, an in-substance financing will be deemed to have occurred. The trade payable should therefore be reclassified to debt on the balance sheet. In this situation, the US SEC's staff position is that the reporting entity should reflect (impute) an operating cash outflow and financing cash inflow related to the affected trade payable.

Additionally, where the buyer does not reflect an operating cash outflow and a financing cash inflow (unlike the US SEC staff's views described above), but presents the liabilities that are part of the supplier finance arrangement as finance payables, clear disclosures about this non-cash transfer should be provided. This is because non-cash transfers can have significant ramifications for the investor's analysis of operating cash flows or free cash flows, and transparency on these transfers should be provided in the notes.

6.2.6 Disclosures

For reporting periods beginning before 1 January 2024, IFRS Accounting Standards do not provide explicit disclosure requirements for supplier finance arrangements. However, general disclosure requirements, including the requirements of IAS 1, apply and need to be considered. Entities need to apply judgement to decide the disclosure required for this period. The 2020 Committee agenda decision includes consideration in this regard.

In May 2023, the IASB introduced additional disclosure requirements that are effective from 1 January 2024, with reliefs provided in the first year of application.

The general objective of the disclosure requirements is for an entity to disclose information about its supplier finance arrangements that enables users of financial statements to assess:

1. the effects of those arrangements on the entity's liabilities and cash flows; and
2. the entity's exposure to liquidity risk and how the entity would be affected if the arrangements were no longer available to it

Disclosures about the impact on liabilities and cash flows (IAS 7)

An entity is required to disclose:

1. The terms and conditions of its supplier finance arrangements (for example, extended payment terms and security or guarantees provided). If the terms and conditions of individual arrangements are not similar, an entity is required to disclose the dissimilar terms and conditions of individual arrangements.
2. As at the beginning and end of the reporting period:
    a. the carrying amounts of the financial liabilities that are part of a supplier finance arrangement and the line items in which those liabilities are presented.
    b. the carrying amounts and associated line items of the financial liabilities disclosed under 2(a) for which suppliers have already received payment from the finance providers.
    c. the range of payment due dates for both financial liabilities that are part of a supplier finance arrangement and comparable trade payables that are not part of a supplier finance arrangement.

PwC insight

Entities might face challenges initially in obtaining the information needed to disclose the carrying amounts for which suppliers have already been paid, and in setting up appropriate controls over the completeness and accuracy of that information. Entities should engage with their finance provider as soon as possible to ensure that they have access to the information needed on a timely basis and are able to put in place appropriate processes and controls over that information.

3. The type and effect of non-cash changes in the carrying amounts of the financial liabilities disclosed under 2(a) (that is, liabilities that are part of a supplier finance arrangement). Examples of non-cash changes include the effect of business combinations, exchange differences and other transactions that do not require the use of cash or cash equivalents. This disclosure requirement also applies for reclassifications between line items in the statement of financial position that are not accompanied by a cash movement.

PwC insight

The disclosure of non-cash changes is a critical element of the disclosure requirements. When the IASB developed these requirements, it received a clear message from investors that they need information to understand the impact of supplier finance arrangements on an entity's cash flows. Without specific disclosures about non-cash changes, the cash flow impact would not always be apparent.

Disclosures about exposure to liquidity risk (IFRS 7)

IFRS 7 requires an entity to provide information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed. IFRS 7 defines liquidity risk as "*the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset*".

The IASB amended IFRS 7 to specifically include the access to facilities under supplier finance arrangements as an example of factors that an entity might consider when providing the disclosure required in relation to liquidity risk. These disclosures will be particularly important if a significant portion of an entity's liabilities are a part of supplier finance arrangements with one of a few providers. In this case, it is important for investors to understand what the impact would be on the entity if the arrangements were no longer available (for example, if a finance provider has the right to withdraw one or more arrangements during times of financial stress).

PwC insight

The liquidity risk disclosures should consider:

- the likelihood of the supplier financing arrangements becoming unavailable as well as the description of the termination of the arrangement (if relevant);
- the financial condition of the provider of the supplier financing; and
- the extent of the buyer's reliance on continued availability of the supplier finance arrangement.

(In depth - Bringing transparency on supplier finance), (FAQ 44.101.1), (EX 44.101.3), (FAQ 7.12.1)

C. Interest rate risk management considerations

7. Cash and liquidity risk management

Interest rate risk management is a crucial aspect of financial management for treasury centres. It involves the identification, measurement, and mitigation of the potential impact of interest rate fluctuations on the organisation's financial position. Interest rate risk management is an important role of a treasury centre for the following reasons:

- Treasury centres often deal with significant financial exposures, making them vulnerable to fluctuations in interest rates. Without careful management this can lead to financial instability.
- Interest rate risk needs to be managed at a group level to allow the entity to make informed decisions about capital allocation and investment, while ensuring consistency and alignment with overall financial objectives.
- Effective interest rate risk management helps the entity to reduce net borrowing costs by optimising debt structures, including both the maturity profile and currency of borrowings
- Centralisation of interest rate risk management allows interest income and expenses to be pushed down to operating units both to optimise the tax effect of net borrowings and to ensure that business units build a cost of capital into their investment decisions.

Treasury centres play a vital role in managing the financial activities of multinational corporations. They are responsible for centralising and optimising cash management, liquidity, and funding operations across various subsidiaries and business units.

7.1 Similarities with foreign currency risk management

Many aspects of interest rate risk management are similar to foreign currency risk management, as discussed in our previous foreign currency risk management chapter:

- Identifying and measuring the risk exposure to effectively manage and mitigate potential losses.
- Implementing appropriate hedging strategies to protect against adverse interest rate movements.
- Ensuring proper accounting treatment and compliance with relevant standards.

7.2 Frequently asked questions

7.2.1 Partial term hedge of a financial asset or financial liability

Often companies decide to only hedge the interest rate risk for a partial term of a financial liability instead of hedging all of its cash flows.

Question

Can cash flows or fair value movements be hedged for only a portion of the time to maturity of the financial asset or financial liability?

Illustration

Entity A acquires a 10% fixed–rate government bond with a remaining term to maturity of ten years. Entity A measures the bond at amortised cost. On the same date, to hedge against fair value exposure on the

bond associated with the first five years' of its life, the entity acquires a five-year pay-fixed, receive-floating swap. The swap has a fair value of zero at the inception of the hedge relationship.

Solution

Yes.

The IAS 39 Implementation Guidance (at former para F.2.17 on partial term hedging) allowed hedging a financial instrument (the hedged item) for only a portion of its cash flows or fair value, if effectiveness can be measured and the other hedge accounting criteria are met. Although IFRS 9 did not carry forward the IAS 39 Implementation Guidance, in its Basis for Conclusions, the IASB emphasised that not carrying forward the Implementation Guidance did not mean that it had rejected that guidance.[IFRS 9 para BC6.95]

The swap could be designated as hedging the fair value exposure of the interest rate payments on the government bond until year 5, and the change in value of the principal payment due at maturity, to the extent affected by changes in the yield curve relating to the five years of the swap.

The same principle applies if the hedged item had been a financial liability instead of a financial asset with the same terms. In that situation, the entity could designate the fair value exposure of the first five years' interest payments due to changes in interest rate only, and hedge that exposure using a five–year receive–fixed, pay–floating interest rate swap.

The entity is also able to achieve hedge accounting for partial term cash flow hedges of financial items. For instance, assume an entity issues a ten–year floating–rate debt and wishes to hedge the variability in the first three years of interest payments using a three–year receive–floating, pay–fixed interest rate swap. The entity could designate the swap as hedging the variability in cash flows arising from the first three years of interest payments.

(FAQ 46.76.2)

7.2.2 Replacing the underlying hedged item

A refinancing of a loan may affect an interest rate risk hedge in different ways depending on how the hedged risk is identified in the original hedge documentation.

Question

Does the replacement of a hedged item result in discontinuance of hedge accounting, if the terms of the new hedged item are substantially different (under IFRS 9 B3.3.6) from the original instrument?

Illustration

Company A is exposed to interest rate risk on interest bearing debt. The company manages its exposure to interest rate risk through the proportion of fixed and variable rate net debt in its total net debt portfolio.

For the current period, Company A's approved strategy in accordance with its risk management policies is to maintain a certain ratio of fixed: floating rate net debt. To meet this chosen ratio, management has decided to enter into interest rate swaps to swap the floating rate of certain debt to fixed. As a result of this risk management strategy the company has designated a cash flow hedge of variable rate debt. In order to manage liquidity risk, the company has a strategy of exchanging existing variable rate debt instruments some time before their maturity with new variable rate instruments (normally with a longer maturity). As the strategy is to replace existing variable rate debt with new variable rate debt the underlying 'cash flow' risk is not changing.

For example: Company A entered into a 10 year debt instrument with the following terms:

- Notional: £50 m
- Interest rate: SONIA + 25bp
- Start date: 30 June 2008
- Maturity date: 30 June 2018

- Interest settlement dates: Semi–annual – 1 January and 30 June.

The interest rate cash flow risk was initially hedged using the following interest rate swap:

- Notional: £50 m
- Receive leg: SONIA
- Pay leg: GBP 5 %
- Start date: 30 June 2008
- Maturity date: 30 June 2018
- Interest settlement dates: Semi–annual – 1 January and 30 June.

The terms of the interest rate swap match the terms of the hedged item.

At 30 June 2016 when the current debt only has 2 years remaining, management decides to extend the term of the funding arrangements for liquidity purposes. Management decides to replace the current debt with debt of a longer maturity. In this scenario, assume the new debt has a maturity of 8 years and has terms (that is, interest settlement dates, interest basis, and currency) similar to that of the current debt. The underlying 'cash flow risk' will still be SONIA related (consistent with the cash flow risk of the 'old debt').

If the terms of the new hedged item are substantially different from the original instrument (that is, the present value of the new debt is more than 10% different than the present value of the remaining cash flows of the old debt), IFRS 9 paragraph B3.3.6 requires de–recognition of the old debt.

Does this:

- Require immediate discontinuation of the hedge relationship and release of the amount deferred in cash flow hedge reserve; or
- Can the amount in cash flow hedge reserve remain in equity if the new debt has similar cash flow risk characteristics to the old debt (that is, also have cash flow risk associated with SONIA) and merely continues to be a hedge of the cash flow risk associated with the first two years of the new 8 year variable rate debt?

Solution

It depends how the hedged risk has been identified in the original hedge documentation.

If the hedged risk has been defined as the cash flow variability from a 'specifically identified debt instrument' then when the original debt instrument is de-recognised, hedge accounting has to be discontinued and the associated cash flow hedge reserve has to be reclassified to profit or loss.

If however the hedged risk has been defined as the '*cash flow variability due to changes in SONIA' and the hedged item as, for example, 'group of forecast interest rate cash flows that are expected to occur with a high degree of probability in specific future periods either from the current debt instrument or any other debt instrument taken out to refinance or otherwise replace the current debt instrument prior to its maturity and that has similar risk characteristics'* – then the new debt instrument may still fall within the designated hedged item. In this case, replacement or restructuring of the current debt instrument would not require discontinuance of hedge accounting (or the associated reclassification to profit or loss of the cash flow hedge reserve), even when the original debt instrument is de-recognised. To ensure continuance of hedge accounting the new underlying debt instrument should have similar cash flow variability risk as the previous debt instrument and meet all of the hedge accounting requirements (including the appropriate hedge effectiveness requirements).

A number of further issues require consideration to determine whether continuation of the current hedge relationship is appropriate:

- If the original hedged cash flows extended beyond management's planning horizon for financing (for example, if management's planning horizon for financing is 7 years, the variable rate debt was issued for a period of 10 years and management does not plan to replace the debt during the 7 year planning

horizon) then the probability of the future cash flows being hedged is supported by the existence of the current loan. As it might be difficult to support the 'highly probable' requirement, the designation would have to be based on the specific loan. In this case it might be difficult to define the hedged risk in a flexible manner that would not only include the 'specific debt instrument'.

- If, however, the hedged cash flows are within management's planning horizon for financing (for example, if management's planning horizon for financing is 7 years, the original variable rate debt was issued for a period of 7 years or less and management plans to replace the debt within the 7 year planning horizon for financing), it might be possible to designate the 'forecast highly probable variable interest rate payments' as the hedged item and not necessarily the cash flows from a specific debt instrument. It is however important that the 'highly probable' requirement is sufficiently supported. The hedged cash flows need to be sufficiently designated to ensure they are clearly identifiable when they occur and all the hedge qualifying criteria are met. (FAQ 46.83.8)

7.2.3 Cash flow hedges of future interest flows

Companies often hedge existing financing and future debt issuances with standard or forward starting interest rate swaps.

Question

Are the following cash flow hedge designations of future interest flows permitted under IFRS 9?

Illustration

Consider the following scenarios. In all scenarios both the swap and the hedged debt are denominated in the Treasury Centre's functional currency.

Scenario 1

Treasury Centre A enters into a forward starting swap in which it pays a fixed rate and receives a floating interest rate to hedge a highly probable forecast debt issuance. The date of issuance is known, but it is not known whether the debt will be at fixed– or floating– rates. Treasury Centre A designates the swap as a cash flow hedge of the variability in cash flows of the debt to be issued, due to changes in interest rates. As a result, the treasury centre considers the following:

- If the forecast issuance is at fixed rate, the swap will be terminated (or an opposing swap with the same residual maturity will be taken out to close the swap position) and hedge accounting will be discontinued.
- If the forecast issuance is at floating–rate, then the hedge relationship is maintained with the existing swap and therefore hedge accounting will continue to be applied.

Scenario 2

Treasury Centre B enters into an interest rate swap in which it pays a fixed rate and receives a floating interest rate. Treasury Centre B designates the swap as a cash flow hedge of the variability, due to changes in interest rates, of the cash flows resulting from a combination of current floating rate debt (with a maturity shorter than that of the swap), followed by a highly probable forecast issuance of either fixed or floating rate debt for the remaining term of the swap (the latter is similar to scenario 1).

Scenario 3

Treasury Centre C enters into a similar structure as in scenario 2 above. However, in this case the precise date when the existing floating debt will be rolled over into either floating– or fixed–rate debt is not known. The treasury centre can demonstrate that it has a highly probable funding requirement of at least CU1 million throughout the life of the swap, which will be satisfied by issuing either fixed– or variable–rate debt. The swap is designated as a cash flow hedge of the variability of future interest cash flows on the first CU1 million of debt in issue over the life of the swap.

Solution

Yes, all of the above designations are allowed under IFRS 9 provided all the qualifying criteria in IFRS 9 6.4.1 are met, including for example that the intention to hedge changes in interest rates is in line with the entity's risk management strategy. Treasury Centres may designate their hedge relationships in alternative ways depending on their facts and circumstances.

Designation of the risks associated with forecast transactions is permitted as long as they are highly probable.

In the case of scenario 3, in which a layer is designated as the hedged item, IFRS 9 6.6.3 requires among other aspects that the layer must be separately identifiable and reliably measurable. The forecast transaction must be identified and documented with sufficient specificity so that when the transaction occurs it is clear whether the transaction is or is not the hedged item. A drawback of designation of a layer is the complexity in proving that the designated level of funding is highly probable. For example, when treasury centres specify the interest payment for a particular loan, then there is no need to prove that the cash flows are highly probable since those are contractually specified. When treasury centres do not designate a specific contract then it is necessary to demonstrate that it is highly probable that there will be a need for a certain level of financing of a kind that meets the designated hedged item.

In all of the above scenarios, where the hedged item is issued floating–rate debt, ineffectiveness may arise, for example if the reset dates or interest basis of the swap differ from those of the issued debt. (FAQ 46.83.6)

7.2.4 Hedging interest and foreign currency risk by designating an aggregated exposure

Sometimes multiple derivatives are used to hedge interest rate risk exposure or to hedge both interest rate and foreign currency risk. These derivatives may be entered into at different times.

Question

Can a treasury centre achieve hedge accounting if it adds an additional derivative to a pre-existing hedge relationship?

Illustration

Treasury Centre TC, which has USD as its functional currency, takes out a 10-year floating rate loan in EUR (a foreign currency). It wants to eliminate its exposure to variability in cash flows from changes in interest rates, so it enters into a floating-to-fixed interest rate swap in EUR. To reduce volatility in P&L, it designates the swap in a cash flow hedge.

In a later period, TC also wants to eliminate the foreign currency exposure, so it takes out a USD:EUR fixed-fixed cross-currency interest rate swap to eliminate its exposure.

Under IFRS 9 can TC achieve hedge accounting by designating the cross-currency interest rate swap as a hedge of the combination of the debt and the existing interest rate swap?

Solution

Yes. Under IFRS 9 the aggregated exposure (that is, a combination of the debt instrument plus the interest rate swap) is eligible to be designated as the hedged item, without needing to de–designate the original interest rate hedge. This is consistent with the treasury centre's strategy of simply overlaying the second derivative to eliminate the net foreign currency risk. (FAQ 46.64.1)

7.2.5 Offsetting internal derivative contracts used to manage interest rate risk

Question

In the consolidated financial statements of a group, can a single external derivative which offsets several internal derivatives qualify as a hedging instrument?

Illustration

Entity A has a number of subsidiaries. All treasury activities of the group are undertaken by the group's treasury centre, TC. Individual subsidiaries intending to hedge their exposure to interest rate risk are required to enter into separate derivative contracts with TC.

TC aggregates the internal derivative contracts and enters into a single external derivative contract that offsets the internal derivative contracts on a net basis. For instance, TC might enter into three internal receive–fixed, pay–variable interest rate swaps (total notional amount of C100m) that lay off the exposure to variable interest cash flows on variable–rate liabilities
in the three subsidiaries, and one internal receive– variable, pay–fixed interest rate swap (notional amount of C80m) that lays off the exposure to variable interest cash flows on variable–rate assets in another subsidiary. It then enters into a receive–variable, pay–fixed interest rate swap (notional amount of C20m) with an external counterparty that exactly offsets the four internal swaps. It is assumed that the hedge accounting criteria are met.

Solution

In entity A's consolidated financial statements, the single offsetting external derivative would not qualify as a hedging instrument in a hedge of an overall net position – that is, it cannot be used to hedge all of the items that the four internal derivatives are hedging, because paragraph 6.6.1 of IFRS 9 only allows a net position to be designated as the hedged item in a cash flow hedge if the hedged risk is foreign currency risk.

However, designating a part of the underlying items as the hedged position on a gross basis is permitted (that is, the external derivative can hedge C20m of variable–rate liabilities totalling C100m). Therefore, even though the purpose of entering into the external derivative was to offset internal derivative contracts on a net basis, hedge accounting is permitted if the hedging relationship is defined and documented as a hedge of a part of the underlying cash inflows or cash outflows on a gross basis and this is consistent with the entity's risk management strategy.

(FAQ 46.100.1)

7.2.6 External derivatives that are settled net

Question

Can several external derivatives with the same counterparty, which are net settled, be designated in separate hedging relationships?

Illustration

Entity A has a number of subsidiaries. All of the group's treasury activities are undertaken by treasury centre TC. Individual subsidiaries intending to hedge their exposure to interest rate risk are required to enter into separate derivative contracts with TC, which in turn enters into a separate offsetting matching derivative contract with a single external counterparty B. For instance, if TC enters into an intra–group receive 5% fixed, pay SOFR interest rate swap, TC would also enter into a separate offsetting pay 5% fixed, receive SOFR interest rate swap with counterparty B.

Although each of the external derivative contracts is formally documented as a separate contract, only the net of the payments on all of the external derivative contracts is settled by TC, as there is a netting agreement with the external counterparty B.

Can each of the external derivatives with the counterparty B, which are net settled, be designated in separate hedging relationships?

Solution

Yes. The individual external derivative contracts, such as the pay 5% fixed, receive SOFR interest rate swap above, can be designated as hedging instruments of underlying gross exposures (such as the exposure to changes in variable interest payments on the pay SOFR borrowing above) in the group's consolidated financial statements, even though the external derivatives are settled on a net basis.

External derivative contracts that are legally separate contracts and serve a valid business purpose (such as laying off risk exposures on a gross basis) qualify as hedging instruments, even if those external contracts are settled on a net basis with the same external counterparty, provided that the hedge accounting criteria in IFRS 9 are met. Note that it would not be considered a valid business purpose if the entity entered into the two transactions only to achieve hedge accounting for one of them (that is, if accounting treatment for one of them was the only reason for entering into two transactions and not one).

It might well be that, by entering into the external offsetting contracts and including them in the centralised portfolio, TC is no longer able to evaluate the exposures on a net basis. As a result, it might decide to manage the portfolio of offsetting external derivatives separately from the entity's other exposures. Thus, it enters into an additional, single derivative to offset the portfolio's risk.

In this situation, the individual external derivative contracts in the portfolio can still be designated as hedging instruments of underlying gross exposures. This is so, even if the final external derivative is effected with the same counterparty under the same netting arrangement and, as a result, might net to zero.

The purpose of structuring the external derivative contracts in the above manner, which is consistent with the entity's risk management objectives and strategies, constitutes a substantive business purpose. Therefore, external derivative contracts that are legally separate contracts and serve a valid business purpose qualify as hedging instruments. In other words, hedge accounting is not precluded simply because the entity has entered into a swap that mirrors exactly the terms of another swap with the same counterparty, if there is a substantive business purpose for structuring the transactions separately.

(FAQ 46.101.1)

7.3 Achieving hedge accounting in practice

For more detailed examples and practical guidance, refer to our publication 'Achieving Hedge Accounting in Practice'. This publication includes detailed illustrations of common interest rate risk hedging strategies.

D. Tax considerations

8. Tax effectiveness

Tax effectiveness is often an important consideration for treasury centres. Section 3.5 explains how a treasury centre's use of intercompany balances and internal derivatives can create accounting mismatches. This section explains how intercompany hedging relationships can also have an impact on taxation.

8.1 Internal and external derivatives

In this section we refer to internal derivatives and external derivatives. External derivatives are generally contracted with unrelated parties outside the consolidated group. Internal derivatives are contracted between the parent and its subsidiaries or between subsidiaries in a group.

While internal derivatives may eliminate on consolidation they can still have a tax impact, given that in many jurisdictions taxes are levied at the statutory entity level rather than based on consolidated financial statements. Accordingly, whether an entity elects to designate external derivatives only or instead chooses to push down hedging to individual subsidiaries using internal derivatives may have tax implications.

In this example we comment on likely tax outcomes for a treasury centre. It is important that management understands the tax regime for the jurisdictions in which the underlying transactions occur and whether such tax regimes are similar to the facts set out in this example.

Consider a group structure with a Parent (P), Operating Subsidiary (OS) and Treasury centre subsidiary (TC). Both OS and TC are direct subsidiaries of P. TC is in a 5% tax jurisdiction and OS is in a 25% tax jurisdiction.

P has a Euro functional currency and OS has a USD functional currency. OS has forecasted purchases in GBP and P wishes to hedge the USD/GBP exchange risk using a forward contract. TC enters a forward contract with a third party bank to purchase GBP and sell USD at a fixed exchange rate which matures in line with the purchase forecast.

It is not necessary for an internal derivative to be used to designate the external USD/GBP forward contract. In P's consolidated group accounts, it may designate the external forward contract directly as a hedge of the USD/GBP risk in OS. However, if no internal forward contract exists, OS will be ineligible to use hedge accounting in its stand-alone accounts, because it is not a party to the forward contract. Furthermore, in many tax jurisdictions, absent an internal derivative entity OS will be taxed only on its external exposure, with no offset from the external derivative. The TC, on the other hand, may be taxed on the external derivative, with no offset in respect of OS's exposure. Accordingly, any gains or losses on the external derivative may be taxable or deductible in TC at a tax rate of 5%, while the underlying transaction will be taxed in OS at a tax rate of 25%. While this may benefit the group if the derivative results in a gain, it may also result in a higher tax bill if the derivative results in a loss.

An alternative structure would involve the use of a back-to-back internal derivative that is executed as a legally binding contract between TC and OS. The internal derivative mirrors the external derivative and results in entity OS being in a similar position to having entered into an external derivative. TC would effectively close its position from an FX perspective because its internal derivative is an offsetting risk position. In such circumstances, OS could designate the internal derivative in a hedge relationship in its standalone accounts. In many tax jurisdictions this would result in the internal derivative being taxable or deductible at OS's 25% tax rate (consistent with the underlying transaction being hedged). Because of its offsetting risk positions TC would likely be tax neutral.

In deciding between the two strategies there are a number of factors to consider, but we set out some of the advantages of each below given the facts above:

External derivative only advantages

- Gains are taxed at a lower rate;
- Less internal contracting is required.

Internal derivative advantages:

- Losses are deductible at a higher rate;
- Possibly more consistent with hedging strategy, if attempting to put OS in a position as if they had purchased at a fixed USD rate;
- Standalone accounts of OS can reflect hedging.

In theory, forward contracts should have about a 50/50 chance of being an asset or liability at maturity. Therefore, using the external derivative only may implicitly be a form of speculation (that is, speculation that the contract will result in an asset at maturity). Entities should consider whether the use of internal derivatives is more reflective of the overall strategy, which will often be to put the subsidiary with the hedged item in the same position as if it had fixed its foreign currency risk. We would recommend an open dialogue between tax and treasury specialists in order to understand the tax implications of using a treasury centre to face the market on behalf of operating units and to discuss the overall strategy for the group from a tax and risk management standpoint.

However, it is worth noting that some jurisdictions may restrict the use of internal derivatives and/or foreign currencies and hence all relevant laws and regulations applicable to such transactions should be carefully considered.

8.2 Pillar Two

8.2.1 What is Pillar Two?

In October 2021, more than 130 countries – representing more than 90% of global GDP – agreed to implement a minimum tax regime for multinationals, 'Pillar Two'. In December 2021, the Organisation for Economic Co-operation and Development ('OECD') released the Pillar Two model rules (the Global Anti-Base Erosion Proposal, or 'GloBE') to reform international corporate taxation. Large multinational enterprises within the scope of the rules are required to calculate their GloBE effective tax rate for each jurisdiction where they operate. They will be liable to pay a top-up tax for the difference between their GloBE effective tax rate for each jurisdiction and the 15% minimum rate. If the GloBE effective tax rate domestically is 15% or more, no GloBE top-up tax will be payable. It is the ultimate parent entity of the multinational enterprise that is primarily liable for the GloBE top-up tax in its jurisdiction's territory.

The goal is to end the 'race to the bottom' on tax rates worldwide, under which countries had been competitively cutting corporate taxes to attract businesses, with the impact that other countries felt forced to cut taxes to compete.

The GloBE rules include two main components: the Income Inclusion Rule ('IIR'); and the Undertaxed Payment Rule ('UTPR'). Top-up tax is first imposed under the IIR on a parent entity with an ownership interest in a low-taxed subsidiary. The UTPR is a backstop mechanism if there is low-taxed income from an entity within the group that is not brought into charge under the IIR by applying a top-up tax in the jurisdiction that introduced the UTPR.

Top-up taxes calculated under the IIR are to be paid in the jurisdiction of the parent entity of the multinational group, rather than in the low-tax territory that triggers the excess payment. Top-up taxes calculated under the UTPR are to be paid by the entity that operates in a jurisdiction that has enacted the UTPR, even if this entity is not a parent entity of the group. Thus, the Pillar Two rules provide for the possibility that jurisdictions might engage in domestic tax policy reforms and introduce their own qualified domestic minimum top-up tax ('QDMTT') based on the GloBE mechanics to avoid any 'tax leakage' in anticipation of the GloBE rules becoming effective.

Notwithstanding any new local minimum tax regime which might be designed to reduce or eliminate the GloBE top-up tax, additional top-up tax under GloBE might still be due. This will depend on the local effective tax rate calculation according to the specific rules set out in the Pillar Two regulations.

8.2.2 Relevance for treasury centres

The Pillar Two rules, as defined by the OECD, apply to multinational enterprises and have implications for treasury centres. A multinational enterprise might therefore be subject to Pillar Two taxes, and within the scope of the IAS 12 disclosure requirements, even if the jurisdiction of the ultimate parent entity has not yet enacted the Pillar Two rules.

Treasury centres are often set up in low tax environments or regimes to take advantage of favourable tax policies. This strategic decision allows multinational corporations to optimise their tax liabilities and enhance their overall financial performance. However, it is important to consider the impact of this low tax environment on revenue figures included in Pillar Two assessments. The revenue generated by treasury centres may be subject to scrutiny and adjustments by tax authorities to ensure fair taxation and prevent profit shifting.

Treasury centres are a key party in setting up internal funding structures within multinational corporations. This involves determining transfer pricing and setting rates on the internal funding structure. The decisions made in this regard have a significant influence on the revenue figures included in Pillar Two assessments for the group and each individual subsidiary (or group of subsidiaries where relevant for the Pillar Two regulation). The allocation of profits and expenses between different entities within the multinational corporation can impact the taxable income and whether a top-up tax for Pillar Two is required and ultimately affect the amount of tax payable by the group.

8.2.3 What is the issue?

Applying the Pillar Two rules and determining the impact are likely to be very complex, and this poses a number of practical challenges. Due to the complexity of the Pillar Two rules, we expect that it will take time for some entities to carry out their impact assessments following the legislation's announcement. As a result, management might be unable to quantify and therefore disclose the detailed effects. However, an entity might be able to provide qualitative information – for example, if a material portion of its business operates in relatively low-tax jurisdictions that are likely to be impacted. For more information refer to the PwC's Pillar Two Readiness microsite.

(Global implementation of Pillar Two: Impact on deferred taxes and financial statement disclosures), (MoA para 14.182-186).