NSW GOVERNMENT | Treasury

Overview on AASB 9 *Financial Instruments*

15 May 2018

Contents

1. Introduction

AASB 9 *Financial Instruments* (**AASB 9**) is effective for NSW public sector agencies from FY2018/19, and replaces AASB 139 *Financial Instruments: Recognition and Measurement* (**AASB 139**).

This Treasury document provides a high-level overview of the key changes in AASB 9. However, agencies still need to review AASB 9 in detail to understand its requirements.

In due course, Treasury will issue a Policy and Guidelines Paper to replace TPP 08-1 *Accounting for Financial Instruments.*

Overview of key changes in AASB 9

- Classification of financial assets is based on the entity's business model and contractual cash flows tests.
- Impairment model has moved from 'incurred' approach to 'expected credit losses'.
- Hedge accounting more closely aligned to how the entity manages its risks.

2. Impact on the State

2.1 Key focus areas

- AASB 9 proposes a new model for classifying and measuring financial assets. Agencies should consistently apply the measurement principles across all financial instruments.
- Agencies will need to revisit their impairment policies.
- More hedging strategies may now qualify for hedge accounting.
- New disclosures on classification, measurement, impairment and hedge accounting.

3. Financial assets - New classification and measurement model

Consistent with AASB 139, all financial assets are initially measured at fair value plus or minus, in the case of a financial asset not at fair value through profit or loss, transaction costs.

However, AASB 9 has introduced changes to classification and measurement. Subsequent to initial recognition, financial assets are measured at:

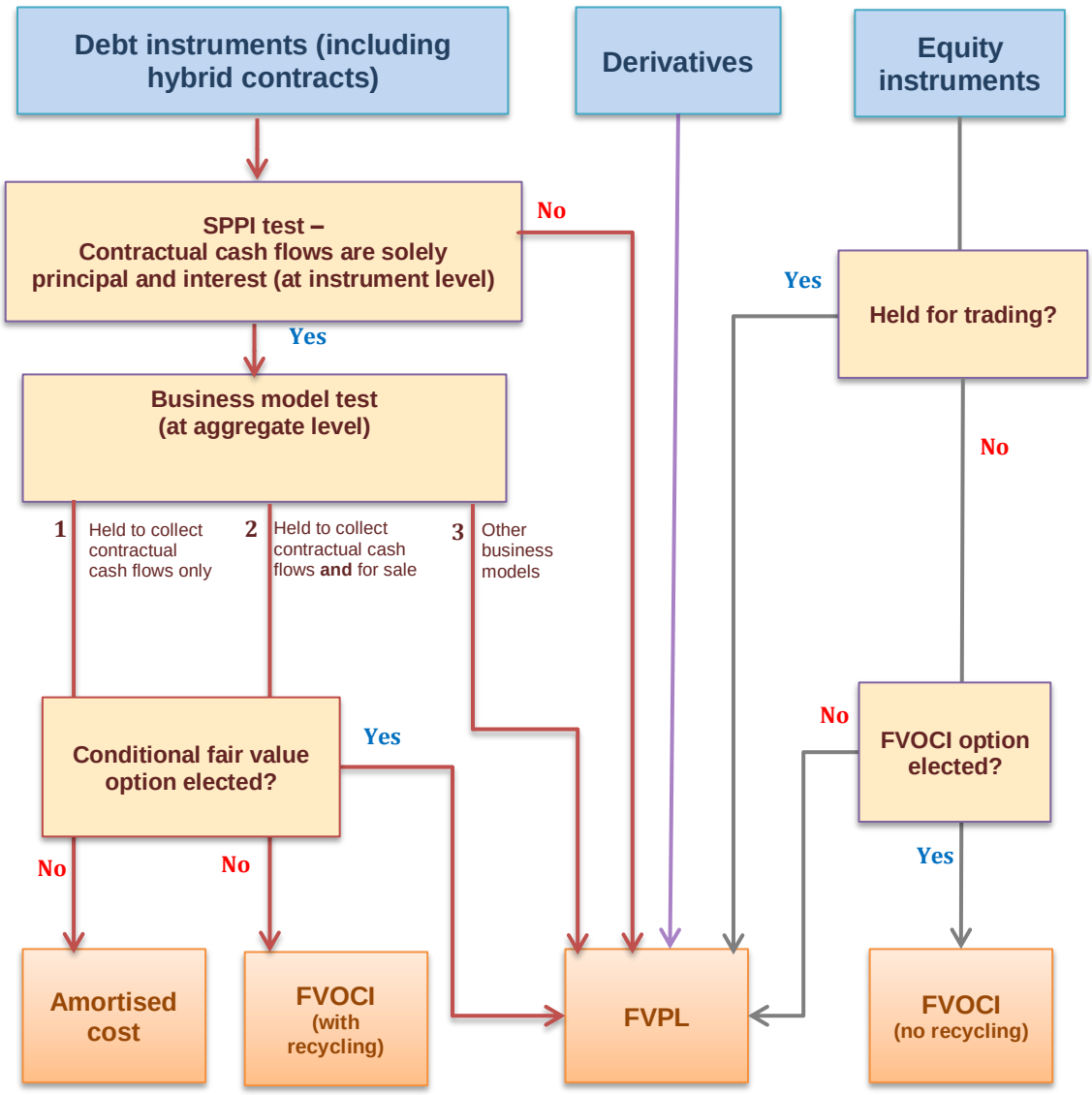
- amortised cost;
- fair value through other comprehensive income (**FVOCI**); or
- fair value through profit or loss (**FVPL**)

AASB 9	**AASB 139**	
Classification and measurement	**Classification**	**Resulting measurement**
Amortised cost	Loans and receivables	Amortised cost
FVPL	FVPL	FVPL
FVOCI	Available for sale	FVOCI
	Held to maturity	Amortised cost

3.1 Overview of the new classification model

Financial assets are classified in their entirety rather than being subject to complex categorisation requirements. The diagram below summarises the three main categories and how certain characteristics tests determine the applicable category.

New classification and measurement model – Financial Assets



Under the new model, FVPL is a residual category. Financial assets are classified as FVPL if they do not meet the criteria of FVOCI or amortised cost.

4. Financial assets - Classification and measurement criteria

4.1 Equity financial assets

Equity instruments are those that meet the definition of 'equity' from the issuer's perspective, as defined in AASB 132 *Financial Instruments: Presentation*.

Equity financial assets (investments in equity instruments) that are held for trading are classified as FVPL [AASB 9.B4.1.6, B4.1.30].

For all other equity financial assets, an irrevocable election to FVOCI is available on initial recognition, on an instrument-by-instrument basis [AASB 9.5.7.5].

If the FVOCI election is made:

- all fair value changes, excluding dividends that are a return on investment, will be included in OCI; and
- there is no recycling from OCI to profit or loss (e.g. on sale of an equity investment);

4.2 Derivative financial assets

Derivative financial assets such as options, swaps, forward contracts etc. should always be classified as FVPL [AASB 9.B4.1.30].

4.3 Debt financial assets

Classification and measurement of debt financial assets (e.g. loans and trade receivables) under AASB 9 is primarily driven by:

- an entity's business model for managing financial assets; and
- their contractual cash flow characteristics: solely payments of principal and interest (**SPPI**).

The order in which the business model and SPPI tests are performed does not impact the classification. However, in many cases it would be efficient to perform the business model test first as this is generally performed at a portfolio level.

4.3.1 Business model test

What is a business model?

Business model refers to how an entity manages its financial assets in order to generate cash flows. The business model is determined by the entity's key management personnel in the way that assets are managed and their performance is reported to them. Detailed guidance on the business model can be found at AASB 9.B4.1.1 – B4.1.6.

In AASB 9, classification of financial assets depends on whether the objective of the entity's business model is to generate cash from:

a) collecting contractual cash flows; or
b) collecting contractual cash flows and selling financial assets; or
c) other

Appropriate level of business model

The business model is determined at a level that reflects how groups of financial assets are managed together to achieve a specific business objective. It is not an instrument-by-instrument analysis, but should be performed at a higher level of aggregation [AASB 9.B4.1.2].

Steps in applying the business model test

1. Segregate the debt financial assets into groups or portfolios based on how they are managed.
2. Identify the entity's objectives in managing each grouping or portfolio.
3. Assess all relevant and objective evidence including:
    - how the business model performance is evaluated and reported to the management
    - risks affecting the performance and how they are managed
    - how business managers are compensated
4. Based on the objectives, classify each group or portfolio as being "held to collect", "held to collect and sell", or "other business models".

Types of business models and appropriate classification

The following table summarises the key features of different business models and the appropriate classification and measurement:

Business model	Key features	Classification and measurement
Held-to-collect [AASB 9.B4.1.2C – B4.1.4]	▪ The objective is to hold assets to collect contractual cash flows ▪ The entity need not hold all the instruments in a group/portfolio until maturity. a) Business model can be 'held-to-collect' even when sales of financial assets are expected to occur in future. b) Sales are incidental to the objective of this model. Factors in making this determination: ⇨ Historical frequency, timing and value of sales ⇨ Reasons for the sale (e.g. credit deterioration of the financial asset) ⇨ Expectations about future sales activity c) Sales are considered incidental if they are: ⇨ due to an increase in the credit risk of the financial asset ⇨ infrequent or insignificant individually and in aggregate ⇨ close to the maturity of the financial asset and the sale proceeds approximate the remaining contractual cash flows	**Amortised cost** **(subject to SPPI test)**

Business model	Key features	Classification and measurement
Held-to-collect and sell [AASB 9.B4.1.4A – B4.1.C]	▪ Both collecting contractual cash flows and sales of financial assets are integral to achieving this business model. ▪ Typically involve a greater frequency and value of sales than a held-to-collect business model. ▪ Examples of this business model: ⇨ Holding financial assets to manage everyday liquidity needs ⇨ Holding financial assets to maintain a specific interest yield profile ⇨ Matching financial assets to the duration of the liabilities funded by those assets (e.g. insurance contract liabilities)	**FVOCI (subject to SPPI test)**
Other business models [AASB 9.B4.1.5 – B4.1.6]	▪ The business model is neither of the above ▪ Examples include: ⇨ *Maximising cash flows through sale* - Assets managed with the objective of realising cash flows through sale ⇨ *Managing assets on a fair value basis* - A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis [AASB 9.4.2.2(b)], e.g. structured products containing embedded derivatives, where the resulting risks are managed on a fair value basis using a mix of derivative and non-derivative financial instruments. ⇨ *Trading* - A portfolio of financial assets that meets the definition of held for trading. For such portfolios, the collection of contractual cash flows is only incidental to achieving the business model's objective.	**FVPL**

Examples of held-to-collect and held-to-collect-and-sell business models are provided at AASB 9.B4.1.4 and B4.1.4C.

4.3.2 Contractual cash flow characteristics – SPPI test

The other criteria determining the classification of financial assets, is whether the cash flows from the financial asset meet the SPPI test. In other words, cash flows that are consistent with a basic lending arrangement. This test is met when the contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest [AASB 9.4.1.2(b) and 4.1.2A(b)].

Meaning of principal and interest

Principal	Principal is the fair value of the financial asset at initial recognition [AASB 9.4.1.3(a)]. The principal amount may change over the life of the financial asset (e.g. if there are repayments of principal) [AASB 9.B4.1.7B]. From the above definition, it is important to note that the principal is not the amount due under the contractual terms, but rather the fair value of the financial asset at initial recognition.
Interest	Interest is the consideration for [AASB 9.4.1.3(b)]: ▪ the time value of money; ▪ the credit risk associated with the principal outstanding at a particular time; ▪ other basic lending risks (e.g. liquidity risk) and costs (e.g. administrative costs); and ▪ profit margin

Key factors relevant in applying the SPPI test

Factor	Description
Time value of money	▪ Time value of money is the element of interest that provides consideration for the passage of time, but not for any other risks or costs associated with the financial asset [AASB 9.B4.1.9A]. For example, a fixed rate bond or loan clearly provides the holder with consideration for the time value of money, whereas an equity investment does not (as the cash flows are not usually specified). This determination involves judgement and consideration of relevant factors such as the period for which the interest rate is set and the currency in which the financial asset is denominated. ▪ AASB 9 discusses the concept of 'modified time value of money' where the relationship between the passage of time and the interest rate may be imperfect, e.g. an asset's interest rate resets every month to a one year rate rather than the one month rate [AASB 9.B4.1.9B]. This introduces a variability in cash flows that is not consistent with a basic lending arrangement. In such circumstances, the entity must consider whether the modification is significant by performing a qualitative or quantitative assessment. If significant, the SPPI test is not met [AASB 9.B4.1.9C-D].
Non-genuine or de minimis payment terms	▪ Such terms should be disregarded in applying the SPPI test as they are either insignificant and/or occur in rare circumstances [AASB 9.B4.1.18]. ▪ Payment terms are not genuine if they affect the contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur. That said, it is uncommon for a contract term to be 'not genuine'. ▪ De minimis or insignificant payment terms would also not impact classification. Payment terms are concluded de minimis only if it is de minimis in each reporting period and cumulatively over the life of the financial asset.

Factor	Description
Rights in the event of bankruptcy	A financial asset will not fail the SPPI test just because it is subordinated to other instruments issued by the debtor. Such a subordinated financial asset may meet the SPPI test if [AASB 9.B4.1.19]: ▪ the debtor's non-payment is a breach of contract; and ▪ the holder of the financial asset has a contractual right to unpaid principal and interest in the event of the debtor's bankruptcy
Option to prepay or extend term	*Prepayment:* A financial asset which would otherwise meet the SPPI test but for the effect of a prepayment option, still meets the test if [AASB 9.B4.1.12]: ▪ the asset is acquired or originated at a premium or discount; ▪ the prepayment is a substantial part of unpaid principal and accrued interest, which may include reasonable additional compensation for the early contract termination; and ▪ the fair value of the prepayment feature is insignificant (usually because it is unlikely that a prepayment will occur) when the entity initially recognises the financial asset *Extension* [AASB 9.B4.1.11(c)]*:* ▪ The SPPI test is met if the extension results in contractual cash flows (during the extension period) that are solely payments of principal and interest ▪ Payments may include a reasonable additional compensation for the extension
Exposure to risks or volatility unrelated to a basic lending arrangement	Financial assets with such features fail the SPPI test because these features do not represent the significant elements of 'interest'. Examples include exposure to changes in equity prices or commodity prices [AASB 9.B4.1.7A].
Leverage	Leverage is a contractual cash flow characteristic of some financial assets [AASB 9.B4.1.9]. Leverage increases the variability of the contractual cash flows and therefore these financial instruments do not contain the economic characteristics of interest, and fail the SPPI test. Examples include stand-alone options, forward and swap contracts. Hence derivatives always fail the SPPI test and are classified as FVPL.
Non-recourse arrangements	Some financial assets with contractual cash flows described as principal and interest may still not pass the SPPI test. This may be the case if [AASB 9.B4.1.15-17]: ▪ the financial asset creates an exposure to specific assets or cash flows of the borrower, instead of an exposure to the borrower's overall credit risk. In other words, the financial assets are investments in specific assets or cash flows wherein the underlying contractual cash flows do not pass the SPPI test, e.g. contingent consideration receivable, whose cash flows are dependent on traffic levels. Such terms are inconsistent with a

Factor	Description
	basic lending agreement as they create significant variability and do not have the economic characteristics of interest. ▪ the creditor's claim is limited to specified assets (or their cash flows) of the debtor If the terms give rise to any other cash flows or otherwise limit the cash flows, the financial asset does not meet the SPPI test. The fact that a financial asset is non-recourse does not in itself necessarily preclude it from meeting the SPPI test [AASB 9.B4.1.17]. For such arrangements, the lender/creditor must 'look through' to the underlying assets or cash flows in making this determination.
Other contingent payment features	The entity may need to assess the nature of any contingent event (i.e. the trigger) that would change the timing or amount of the contractual cash flows [AASB 9.B4.1.10]. Some lending agreements include contingent payment terms which could change the timing or amount of contractual cash flows for reasons other than changes in market rates of interest, prepayments or term extensions. In such instances, an entity must assess the nature of the contingent event. Though not a determinative factor, the nature of the contingent event is an indicator whether the contractual cash flows meet the SPPI test. For example, a financial instrument whose interest rate is reset if the debtor misses a specific number of payments is likely to meet the SPPI test because the terms are consistent with a basic lending arrangement. Contrastingly, a financial instrument whose interest rate is reset if a specified equity index reaches a particular level is likely to fail the SPPI test because these features do not represent the significant elements of 'interest'.

A debt financial asset that meets the SPPI test will be classified as measured at amortised cost or FVOCI depending on the outcome of the business model test (see Section 4.3.1 above). If the SPPI test is not met, the debt financial asset will be measured at FVPL.

Agencies should review the examples in the application guidance section of AASB 9 to understand the application of the business model test [AASB 9.B4.1.4, 4C] and SPPI test [AASB 9.B4.1.13-14].

5. Financial liabilities – Classification and measurement

5.1 Minor change compared to AASB 139

Except for financial guarantee contracts and loan commitments that are scoped out of the standard, financial liabilities are measured either at FVPL or at amortised cost.

The classification and measurement of financial liabilities under AASB 9 is substantially the same as in AASB 139, except where an entity designates financial liabilities at FVPL. For such liabilities, the change in their value is always recognised in profit or loss under AASB 139. However, AASB 9 requires a split presentation.

Under AASB 9, fair value changes of liabilities designated at FVPL are presented as follows [AASB 9.5.7.7]:

- the fair value changes attributable to changes in the liability's credit risk are recognised in OCI; and
- the remaining changes in the fair value are recognised in profit or loss

What is a liability's credit risk?

AASB 9 retains the existing definition of a credit risk in AASB 7: 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'.

However, AASB 9 contains expanded application guidance. A liability's credit risk is a risk that the issuer will fail to perform on the particular liability. This is different from the general credit worthiness of the issuer [AASB 9.B5.7.13].

For example, the credit risk of a collateralised liability of the issuer will be less than the credit risk of an otherwise identical uncollateralised liability.

5.2 Exceptions to the split presentation

The following are exceptions to the split presentation discussed above:

- the split presentation would create or enlarge an accounting mismatch in profit and loss [AASB 9.5.7.8]; or
- the liability is a loan commitment or financial guarantee contract [AASB 9.5.7.9]

In the above exceptions, all changes in fair value of the financial liability are recognised in profit or loss.

6. Reclassification of financial instruments

AASB 9 requires financial assets to be reclassified when, and only if, an entity changes its business model for managing financial assets [AASB 9.4.4.1]. Financial liabilities cannot be reclassified [AASB 9.4.4.2].

Business model changes are expected to be very infrequent and determined as a result of external or internal changes. These changes must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations, e.g. acquisition, disposal or termination of a business line [AASB 9.B4.4.1].

The following are not changes in business model [AASB 9.B4.4.3]:

- a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions)
- the temporary disappearance of a particular market for financial assets
- a transfer of financial assets between parts of the entity with different business models.

When an entity reclassifies financial assets, the reclassification should be prospective from the first day of the next reporting period following the change in business model [AASB 9.5.6.1 and Appendix A]. Prior periods are not restated.

Even if there is a change in business model, an entity would still not be able to reclassify:

- financial assets that have been designated at FVPL; or
- equity instruments that have been designated as at FVOCI

Such designations are irrevocable [AASB 9.4.2.2 and 9.5.7.5].

7. Impairment – Overview

7.1 Key changes

- AASB 9 impairment requirements are based on the 'expected credit losses' (ECL) model. This replaces the 'incurred losses' approach under AASB 139.
- The ECL model broadens the information that an entity is required to consider when determining its expectations of impairment.
- A single set of impairment requirements applies to all financial instruments in the scope of AASB 9, other than those measured at FVPL.
- Entities are required to recognise an allowance for either 12-month or lifetime ECL, depending on whether there has been a significant increase in credit risk since initial recognition.
- The measurement of ECL reflects:
  - ⇨ a probability-weighted outcome;
  - ⇨ time value of money; and
  - ⇨ reasonable and supportable information about past events, current conditions and future forecasts
- Increased disclosures around inputs, assumptions and techniques used in estimating the ECL requirements, to provide greater transparency over credit risk and provisioning.

7.2 Scope

The following table sets out the financial instruments that are in and out of scope of AASB 9 impairment requirements [AASB 9.2.1]:

In scope	Out of scope
▪ Debt financial assets measured at amortised cost or FVOCI ▪ Loan commitments issued and financial guarantee contracts not measured at FVPL ▪ Lease receivables in scope of AASB 117 *Leases* (**AASB 117**) ▪ Contract assets in scope of AASB 15 *Revenue from contract with customers* (**AASB 15**)	▪ Equity investments* ▪ Financial instruments measured at FVPL

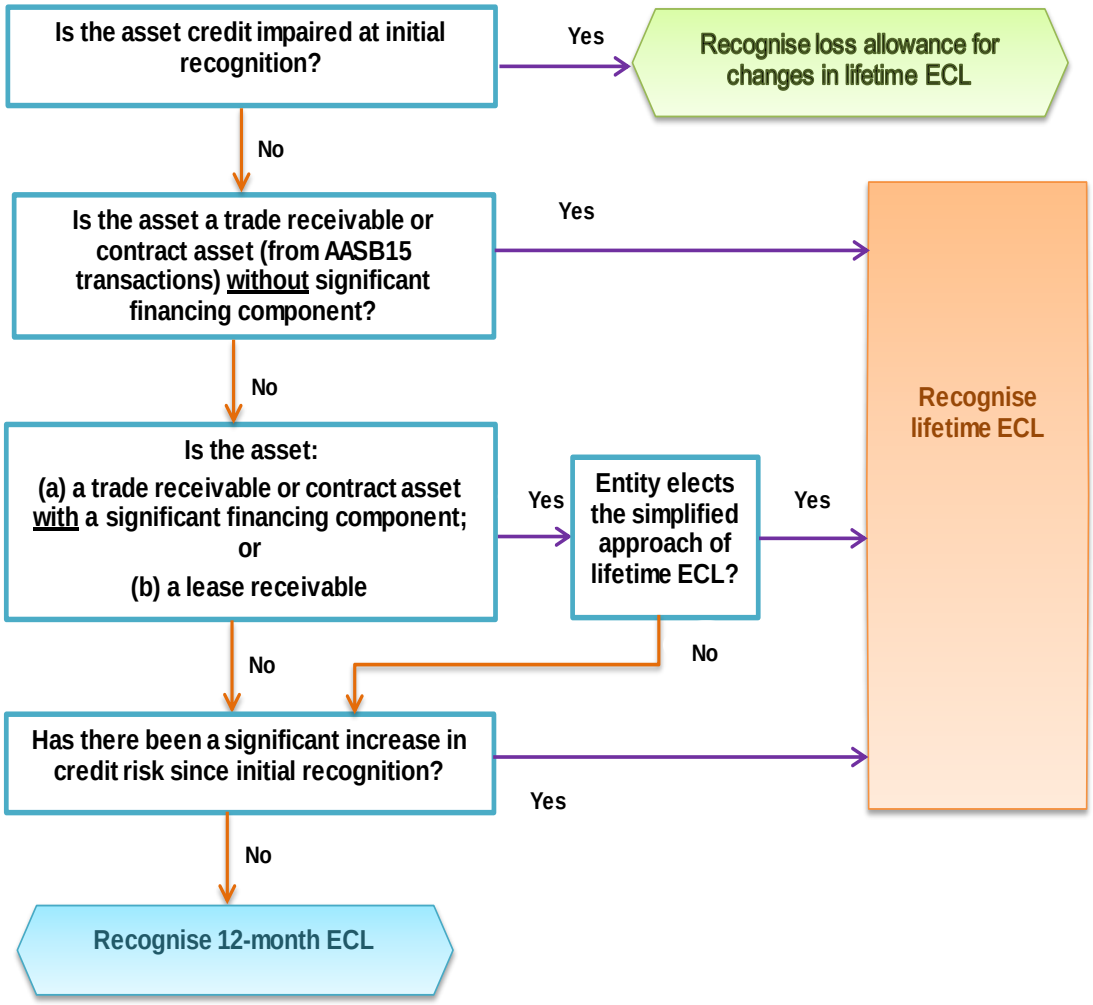
***** Investments in equity instruments are outside the scope of the new impairment requirements, because under AASB 9 they are accounted for either at:

- FVPL [AASB 9.4.1.4]; or
- FVOCI, with no reclassification of any fair value gains or losses to profit or loss [AASB 9.5.7.5]

Accordingly, equity investments in scope of AASB 9 are no longer tested for impairment.

7.3 New impairment model

Under AASB 9 impairment model, ECL are measured as either 12-month or lifetime ECL. The flowchart below sets out the decision tree on determining the appropriate measurement basis:



7.4 Key impairment concepts

Refer Appendix A of AASB 9.

What are credit losses?

Credit losses are essentially 'cash shortfalls'. This is the difference between all contractual cash flows due to an entity and all the cash flows that the entity expects to receive.

This difference is discounted at the original effective interest rate (used in the initial measurement of the financial instrument) or credit-adjusted effective interest rate for financial assets that are credit-impaired at initial recognition.

What are ECL?

ECL are the weighted average of credit losses with the respective risks of a default occurring as the weights. In other words, they are a probability-weighted estimate of credit losses (i.e. the present value of all cash shortfalls) over the expected life of the financial instrument.

What are lifetime ECL?

These are ECL that result from all possible default events over the expected life of a financial instrument. In other words, lifetime ECL are the expected shortfalls in contractual cash flows, considering the potential for default at any point during the life of the financial instrument.

What are 12-month ECL?

These are a portion of lifetime ECL. They represent the ECL from default events that are possible within the 12 months after the reporting date.

They are calculated as [AASB 9.B5.5.43]:

Probability of a default occurring in the next 12 months (X) Total (lifetime) ECL from that default

It is important to note that 12-month ECL are not:

- expected cash shortfalls over the next 12 months; or
- credit losses on instruments that are forecast to actually default in the next 12 months

What is a significant increase in credit risk?

The loss allowance for a financial instrument is always measured as lifetime ECL if, at the reporting date, the credit risk on the instrument has increased significantly since its initial recognition. This assessment is critical and involves considerable judgement [AASB 9.5.5.3].

In making this assessment, the entity should [AASB 9.5.5.9]:

- consider the change in risk of default over the expected life of the instrument
- compare the current risk of a default at the reporting date with the risk of a default at initial recognition

Note that the change in the magnitude of ECL is not considered for the above assessment, although they are incorporated in the resulting measurement of ECL [AASB 9.5.5.9].

Practical expedient

As a practical expedient, an entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date [AASB 9.5.5.10].

This will relieve entities from tracking changes in the credit risk of high quality assets. This election can be made on an instrument by instrument basis.

7.5 Expected credit losses – Example: 12-month ECL vs lifetime ECL

The principles in this example are elaborated in Section 8 and 9 below.

Entity A advances a 5-year interest bearing loan of $1 million to Entity B on 1 July 2018. Entity A estimates the following:

Period	Risk of default in 12 months (A)	Additional risk of default in 13-60 months (B)	Credit loss resulting from default (C)	Lifetime ECL (A+B)*C
At 1 July 2018	5%	8%	300,000	39,000
At 30 June 2019	6%	15%	200,000	42,000
At 30 June 2020	3%	6%	100,000	9,000

Recognition at 1 July 2018

On initial recognition, Entity A should recognise a **loss allowance** equal to 12-month ECL because the loan receivable is not credit impaired at initial recognition.

12-month ECL => $300,000 * 5% = $15,000

Recognition at 30 June 2019

Entity A should evaluate if there is a significant increase in credit risk since initial recognition. Let us assume Entity A assessed the 8% increase (21% (total risk) minus 13%) to be significant. Consequently, the ECL should be based on lifetime ECL.

Lifetime ECL => $200,000 *(6%+15%) = $42,000

Entity A recognises a **loss allowance** of $27,000 ($42,000 minus $15,000 recognised initially) in profit or loss.

Recognition at 30 June 2020

Entity A should again evaluate if there is a significant increase in credit risk since initial recognition. Let us assume Entity A assessed the risk to be not-significant because of 8% drop (from 13% (total risk) in 1 July 2018 to 9% in 30 June 2020). Consequently, the ECL should be based on 12-month ECL.

12-month ECL => $100,000 *(3%) = $3,000

Entity A recognises an **impairment gain** of $39,000 ($42,000 recognised previously minus $3,000) in profit or loss.

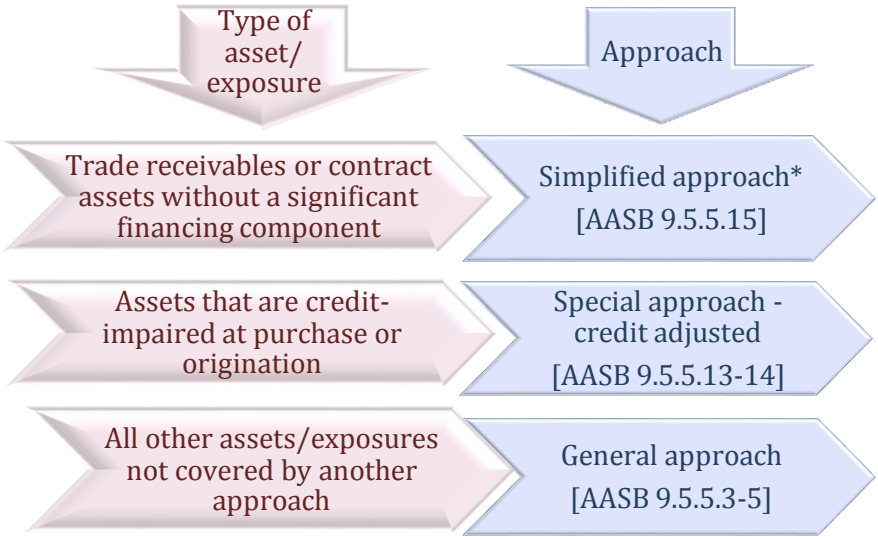
7.6 Comparison to AASB 139 impairment requirements

AASB 139 prescribes different impairment models for financial assets at amortised cost and FVOCI. However, under AASB 9 a single set of impairment requirements applies to all financial instruments in the scope of AASB 9, that are not measured at FVPL. The table below sets out the various elements of impairment and their treatment under AASB 9 and AASB 139.

Description	**AASB 9 – At amortised cost or FVOCI**	**AASB 139**	
		At amortised cost	At FVOCI
Recognition method	Loss allowance	Either by direct reduction of the asset or an allowance	Decline in fair value transferred from OCI to profit and loss
Recognition basis	ECL	Objective evidence of impairment	Objective evidence of impairment
Measurement basis	12-month ECL or lifetime ECL	Carrying amount (LESS) PV of estimated future cash flows	Acquisition cost net of principal repayment and amortisation (LESS) current fair value (LESS) any previously recognised impairments

8. Impairment – Approaches

AASB 9 prescribes different approaches in applying the new impairment model, depending on the type of asset or exposure, as set out below:



*also applicable, if elected, to trade receivables or contracts with a significant financing component, and lease receivables

8.1 General approach

Under the general approach, an entity recognises a loss allowance based on:

- 12-month ECL – if the credit risk of the financial instrument has **not** increased significantly since initial recognition [AASB 9.5.5.3]; or
- lifetime ECL – if there **has** been a significant deterioration in credit quality since initial recognition [AASB 9.5.5.5].

The general approach is typically a three-step process in recognising a loss allowance. This covers financial instruments with varying degree of credit quality as set out below:

Step 1 (performing instruments)	Step 2 (under-performing instruments)	Step 3 (non-performing instruments)
Financial instruments that have not deteriorated significantly in credit quality since initial recognition [AASB 9.5.5.5]	Financial instruments that have deteriorated significantly in credit quality since initial recognition but do not have objective evidence of a default event [AASB 9.B5.5.1]	Financial assets that have objective evidence of impairment at the reporting date [AASB 9.B5.5.3-4]
Recognise 12-month ECL	Recognise lifetime ECL	Recognise lifetime ECL
Interest revenue is calculated on the gross carrying amount of the asset [AASB 9.5.4.1]	Interest revenue is still calculated on the gross carrying amount of the asset [AASB 9.5.4.1]	Interest revenue is calculated on the net carrying amount (i.e. reduced for ECL) [AASB 9.5.4.1]

Note:

Under AASB 9, interest revenue on financial assets is calculated using the effective interest method, similar to AASB 139. This is done by using the effective interest rate **(EIR)** to allocate interest revenue over the expected life of the financial asset.

The EIR is applied to the gross carrying amount of a financial asset except for financial assets [AASB 9.5.4.1]:

- credit-impaired at initial recognition (refer (c) below); or become
- credit impaired subsequently, i.e. have objective evidence of impairment at the reporting date

8.2 Simplified approach

Under the simplified approach, an entity is not required to determine whether a financial instrument's credit risk has increased significantly since initial recognition. Instead a loss allowance is recognised based on lifetime ECL at each reporting date.

The simplified approach applies to the following financial assets [AASB 9.5.5.15]:

Instrument	Simplification
Trade receivables and contract assets which do not contain a significant financing component (in accordance with AASB 15)	Always recognise loss allowance at lifetime ECL
Trade receivables and contract assets which contain a significant financing component	Entities can elect to recognise loss allowance at lifetime ECL
Lease receivables within the scope of AASB 117	Entities can elect to recognise loss allowance at lifetime ECL

Determining whether there has been a significant increase in credit risk is challenging and involves considerable judgement. Consequently, the use of a lifetime ECL is simpler than a 12-month ECL because an entity is not required to keep tracking changes in the credit risk of the underlying financial instrument.

8.3 Special approach (credit adjusted)

AASB 9 prescribes a specific approach for assets that are credit impaired at the date of initial recognition, i.e. assets that are credit-impaired at purchase or origination.

Under this approach, the entity should [AASB 9.5.4.1 and 5.5.13]:

- apply the credit-adjusted EIR to the amortised cost of the financial asset from initial recognition
- subsequently recognise the cumulative changes in lifetime ECL

Financial assets credit-impaired at initial recognition

A financial asset is credit-impaired when one or more events that have a detrimental impact on estimated future cash flows of that financial asset have occurred [AASB 9.Appendix A].

Credit-adjusted EIR

This rate is calculated as estimated contractual cash flows after deducting lifetime ECL [AASB 9.Appendix A]. For example:

Estimated gross future cash inflows on a financial asset - $1,000; Lifetime ECL determined at initial recognition - $ 200. The credit-adjusted EIR is calculated based on the internal rate of return on net cashflows of $800 ($1,000 minus $200).

9. Impairment – Measurement of ECL

9.1 Definition

Expected credit losses
The weighted average of credit losses with the respective risks of a default occurring as the weights [AASB 9.Appendix A].

AASB 9.B5.5.28 explains that this is *'the present value of all cash shortfalls over the expected life of the financial instrument'*. i.e. for financial assets:

The present value of:
Contractual cash flows LESS Cash flows the entity expects to receive

9.2 Overview

AASB 9 does not prescribe a specific method of measuring ECL, instead acknowledges that the measurement could vary based on the type of financial instrument and the information available [AASB 9.B5.5.12]. The measurement of ECL should reflect [AASB 9.5.5.17]:

- an unbiased and probability-weighted amount
- the time value of money; and
- reasonable and supportable information

9.3 Probability weighted outcome

An unbiased and probability-weighted amount requires evaluation of a range of possible outcomes. In practice, this may not need to be a complex analysis.

In some cases, relatively simple modelling may be sufficient, without the need for a large number of detailed simulations of scenarios. For example, for a large group of financial instruments with shared risk characteristics, the average credit losses may be a reasonable estimate of the probability-weighted amount [AASB 9.B5.5.42].

In other instances, this could involve identifying possible scenarios that specify:

- the amount and timing of the cash flows for particular outcomes; and
- the estimated probability of these outcomes

An entity is not required to identify every possible scenario, but should always reflect at least the following two scenarios [AASB 9.5.5.18]:

- possibility that a credit loss occurs, even if this probability is low; and
- possibility that no credit loss occurs

9.4 Time value of money

ECL should be discounted to the reporting date using the EIR determined at initial recognition or an approximation thereof [AASB 9.B5.5.44].

The table below sets out the discount rates to be used for different types of financial instruments [AASB 9.B5.5.44-48]:

Instrument	Discount rate
Credit-impaired financial assets at purchase or origination	Credit-adjusted EIR determined at initial recognition (refer VII(c) above)
Lease receivables	Same rate used in measuring lease receivables in accordance with AASB 117
Loan commitments	EIR, or an approximation thereof, that will be applied when recognising the financial asset resulting from the loan commitment
Loan commitments for which the EIR cannot be determined; and Financial guarantee contracts	Rate that reflects the current market assessment of the time value of money and the risks specific to the cash flows (but only if, and to the extent that, the risks are factored by adjusting the discount rate instead of the cash shortfalls being discounted)

9.5 Reasonable and supportable information

This is information which is reasonably available at the reporting date without undue cost or effort, including information about past events, current conditions and forecasts of future economic conditions [AASB 9.B5.5.49]. The information used should include [AASB 9.B5.5.51]:

- factors that are specific to the borrower; and
- general economic conditions and an assessment of both the current as well as the forecast direction of conditions

The entity is not required to [AASB 9.B5.5.50-51]:

- incorporate forecasts of future conditions over the entire expected life of a financial instrument. For periods far in future, an entity could develop projections by extrapolating the information available for earlier periods
- undertake an exhaustive search for information. However, entities should consider all reasonable and supportable information available without undue cost or effort.

Data sources

Examples of possible data sources include [AASB 9.B5.5.51]:

- internal historical credit loss experience
- internal ratings
- credit loss experience of other entities
- external ratings, reports and statistics

Entities that have no, or insufficient, sources of entity-specific data may use peer group experience for the comparable financial instrument (or groups of financial instruments).

Historical information

Historical information is a useful base to measure ECL, but may need to be adjusted to reflect current conditions. Estimates of changes in ECL should reflect, and be directionally consistent with changes in related observable data from period to period. Examples of observable data – unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of credit losses [AASB 9.B5.5.52].

10. Hedge Accounting

10.1 Overview

The new hedge accounting requirements under AASB 9 aim to align hedge accounting more closely with an entity's risk management activities [AASB 9.6.1.1].

What has changed compared to AASB 139?

- increase in eligibility of hedging instruments and hedged items, thereby reduced volatility
- minor revision in qualifying criteria for hedge accounting
- change in criteria for measuring hedge effectiveness
- a new concept of rebalancing hedging relationships
- new requirements restricting the discontinuance of hedge accounting

What has <u>not</u> changed?

- hedge accounting continues to be optional
- the three types of hedge accounting (fair value hedges, cash flow hedges and hedges of a net investment) remain
- requirement to formally designate and document hedge accounting relationships
- ineffectiveness needs to be measured and included in profit or loss
- hedge accounting cannot be applied retrospectively

Description of change

The mechanics of hedge accounting under AASB 9 remains broadly the same in terms of the accounting for the hedging instrument and hedged item on various types of hedges.

However, what has changed are the requirements for what qualifies for hedge accounting. This includes replacing some of the arbitrary rules with more principle-based requirements and allowing more hedging instruments and hedged items to qualify for hedge accounting. This should result in more risk management strategies qualifying for hedge accounting.

These changes aim to achieve the following objectives:

- Align the accounting for hedges more closely with the risk management strategy of an entity
- Improve the disclosure of information about risk management activities

10.2 Policy choice on transition

On transition to AASB 9, entities have a choice to continue applying the hedge accounting requirements of AASB 139 instead of applying the new requirements in AASB 9 until the International Accounting Standard Board's (IASB) macro hedge accounting project is completed [AASB 9.7.2.21].

This accounting policy choice should be applied to all hedge relationships, i.e. it cannot be applied on a hedge-by-hedge basis. Entities that have chosen to continue with AASB 139 can adopt AASB 9 in any subsequent reporting period. However, once an entity has chosen to apply AASB 9, it will not be possible to revert back to AASB 139 [AASB 9.7.2.27].

NSW Treasury will mandate the policy choice in due course.

10.3 Qualifying criteria for hedge accounting

A hedging relationship qualifies for hedge accounting only if all the following criteria are met [AASB 9.6.4.1]:

- The hedging relationship consists only of eligible hedging instruments and eligible hedged items (in their entirety or components thereof);
- At inception of the hedging relationship, there is a formal designation and documentation of:
  - the hedging relationship between the identified hedging instrument and hedged item;
  - the entity's risk management objective and strategy for undertaking the hedge;
  - nature of risk being hedged; and
  - hedge effectiveness (including sources of ineffectiveness and how the hedge ratio is determined)
- The hedging relationship meets the hedge effectiveness requirements (see Section 10.4 below)

10.4 Requirements for hedge effectiveness

AASB 9 introduces the following hedge effectiveness requirements:

(a) There must be an economic relationship between the hedged item and the hedging instrument [AASB 9.B6.4.4-5].

Broadly this means there must be an expectation that the value of the hedging instrument and the hedged item will move in the opposite direction as a result of the hedged risk [AASB 9.B6.4.4-5].

(b) Credit risk should not dominate the value changes from the economic relationship. In other words, even if there is an economic relationship, a change in the credit risk of the hedging instrument or the hedged item must not be of such magnitude that it dominates the value changes from that economic relationship [AASB 9.B6.4.7].

(c) The designated hedge ratio is consistent with the entity's risk management strategy. The hedge ratio is defined as the relationship between the quantity of the hedging instrument and the hedged item in terms of their relative weighting [AASB 9.B6.4.9-10].

However, that designation should not reflect an imbalance between the relative weightings that would create hedge ineffectiveness.

10.5 Rebalancing

AASB 9 introduces the concept of 'rebalancing' in instances where the hedging relationship no longer meets the hedge effectiveness requirement, but the risk management objective has remained the same. Under this, the hedge ratio may be adjusted so that it meets the effectiveness criteria again [AASB 9.B6.5.7-21].

Adjustments can be made to designated quantities of the hedged item or the hedging instrument to maintain a hedge ratio that complies with the hedge effectiveness requirements. Such adjustments 'rebalance' the hedge so that it meets the qualifying criteria again.

Outcome

Rebalancing does not result in de-designation or re-designation of a hedge, but it is accounted for as a continuation of the hedging relationship. However, on rebalancing, any hedge ineffectiveness is determined and recognised immediately before adjusting the hedge relationship [AASB 9.B6.5.8].

When rebalancing a hedging relationship, an entity must update its documentation of the sources of hedge ineffectiveness expected to affect the hedging relationship for its remaining term [AASB 9.B6.5.21].

When is rebalancing not allowed?

In circumstances where:

- there is indication that the hedge ratio no longer reflects the relationship between hedging instrument and the hedged item [AASB 9.B6.5.12]; or
- the risk management objective has changed [AASB 9.B6.5.15]

rebalancing is not allowed, and hedge accounting should be discontinued.

Examples where the hedge ratio no longer reflects the hedging relationship:

- changes in the derivative counterparty credit risk
- a risk that was always present but not captured by the hedging instrument.

10.6 Discontinuation of hedge accounting

Under AASB 139, an entity could voluntarily discontinue hedge accounting by simply revoking the designation of the hedging relationship.

However, voluntary de-designation is prohibited under AASB 9 [AASB 9.6.5.6]. The entity cannot de-designate and thereby discontinue a hedging relationship that [AASB 9.B6.5.23]:

- still meets the risk management objective; and
- continues to meet all other qualifying criteria (after considering any rebalancing, if applicable)

When is discontinuation allowed? [AASB 9.B6.5.26]

An entity discontinues hedge accounting prospectively only when the hedging relationship (or part of it) ceases to meet the qualifying criteria (after any rebalancing). This includes instances when the hedging instrument expires or is sold, terminated or exercised.

Discontinuing hedge accounting can either affect a hedging relationship in its entirety or only a part of it (in which case hedge accounting continues for the remainder of the hedging relationship).

Risk management strategy Vs Risk management objective [AASB 9.B6.5.24]

AASB 9 distinguishes between the two. This difference is important in the context of discontinuation.

Risk management strategy

An entity's risk management strategy is established at the highest level at which it manages risk. This typically identify the risks to which the entity is exposed and set out how the entity responds to them.

Such strategies are usually in place for a longer period and might include some flexibility to react to changes in circumstances (e.g. changes in interest rate or commodity price levels). These are normally general documents cascaded down through policies containing more specific guidelines.

Risk management objective

In contrast, a risk management objective is applied at the level of a specific hedging relationship. It relates to how the designated hedging instrument is used to hedge the specific exposure designated as the hedged item.

A risk management strategy can and often does involve many different hedging relationships, each with a risk management objective. Hence, the risk management objective for a specific hedging relationship can change, even if an entity's risk management strategy remains unchanged.

If the risk management objective for a hedge relationship has changed, hedge accounting must be discontinued.

10.7 Snapshot of the key areas of change compared to AASB 139

Description	Summary of key changes
Hedge effectiveness testing	This is prospective only and can be qualitative, depending on the complexity of the hedge. The 80-125% quantitative range is replaced by more principles-based qualifying criteria. The focus now is on the economic relationship between the hedged item and the hedging instrument, and the effect of credit risk on that relationship.
Risk component	Risk components can be designated (as the hedged item), not only for financial items, but also for non-financial items, provided the risk component is separately identifiable and reliably measurable. This is beneficial for commodity price risk hedges, where that is only a component of the overall price risk of the item.
Costs of hedging	The time value of an option, the forward element of a forward contract and any foreign currency basis spread can be excluded from the designation of a financial instrument as the hedging instrument and accounted as costs of hedging. These are recognised in OCI and reclassified to profit or loss in a manner dependent on the hedged item. Under AASB 139, such costs would either have been accounted for at FVPL, or included in the hedging relationship causing ineffectiveness.
Groups of items	More designations of groups of items as the hedged item are possible, including layer designations. It is common to group similar risk exposures and hedge only the net position, hence AASB 9 allows the potential to align the accounting approach with the risk management strategy. AASB 139 allowed hedging layers of a group in very limited circumstances (e.g. in specified cash flow hedges). AASB 9 commonly allows a layer of a group to be designated as the hedged item. Example of a layer component – a part of a physical or other transaction volume (such as the first 100 barrels of the oil purchases or the first 100 MWh of electricity sales).
Disclosures	Extensive and require more meaningful information and insights.