AASB 9 *Financial Instruments*

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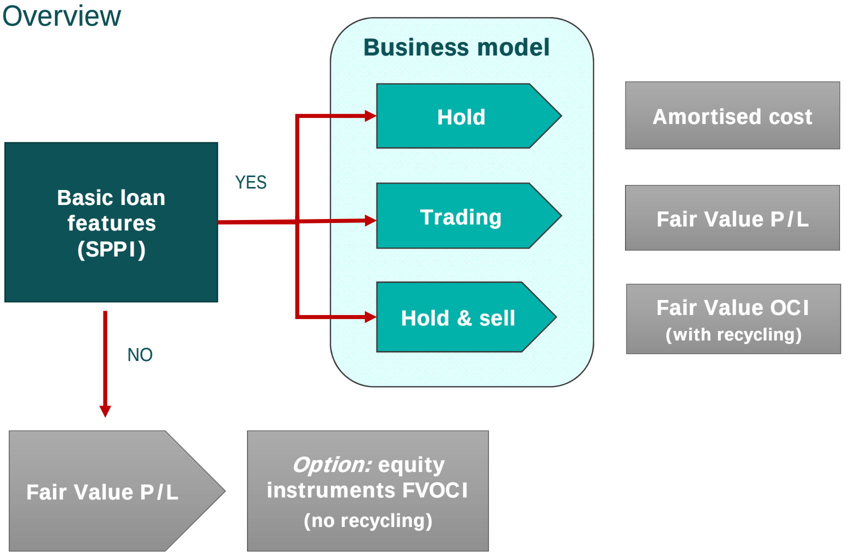
Introduction

- Applies retrospectively from 1 January 2018
- Standard + AG + IE + IG = 295 pages
- Classification and measurement of financial assets
- Impairment of financial assets
- Reclassifications
- Financial liabilities
- Hedge accounting
- Transition

Classification and measurement of financial assets

Financial Asset Classification

Overview



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Basic loan features

Solely Payments of Principal &
Interest (SPPI)

Basic Loan Features

Contractual cash flow characteristics test

- Must be Solely Payments of Principal and Interest (SPPI)
- 'Interest' includes elements relating to:
  - the time value of money
  - credit risk
  - liquidity risk
  - a profit margin and servicing costs
- Embedded features
  - Eg, conversion option into shares
  - Fails SPPI unless non-genuine or *de minimus*

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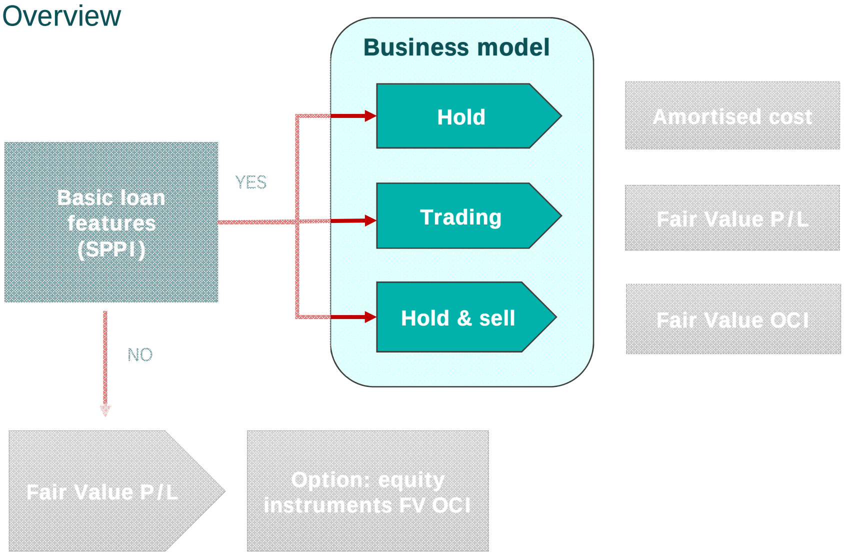
Business model test

Financial Asset Classification

Overview



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Financial Assets at Amortised Cost

Business model test

- How groups of financial assets are managed together to achieve a particular business objective
- How they generate cash flows
  - Collecting contractual cash flows;
  - Selling / trading; or
  - Both hold and trade
- Based on fact not intention

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Financial Assets at Amortised Cost

Business model test - Factors to consider

- How performance evaluated and reported to key management personnel
- Not instrument-by-instrument approach
- May be business unit, portfolio or entity level
- May have more than one business model for managing financial assets
  - Portfolio of investments that the entity manages in order to collect contractual cash flows
  - Another portfolio of investments that it manages in order to trade to realise fair value changes
- Individual exceptions don't taint classification
  - But more than infrequent trading may trigger reclassification

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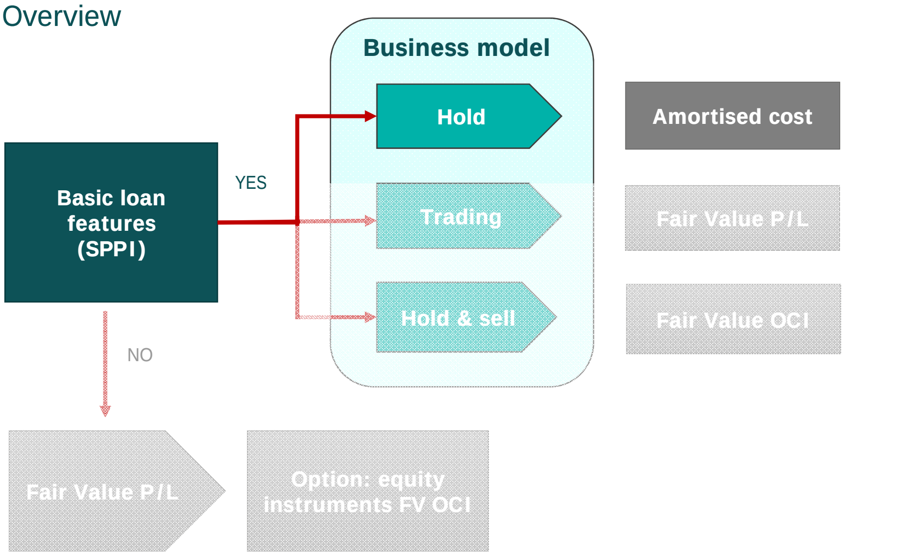
Financial Asset Classification

Overview



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Financial Assets at Amortised Cost

Contractual cash flow characteristics test

Hold to collect cash flows business model - Examples

- Trade receivables arising under AASB 15 *Revenue from Contracts with Customers*
- Loans from a subsidiary or its parent
  - whether interest-free or interest bearing
- Other loans and receivables
- Government or corporate bonds
- Cash and cash equivalents
- Assets that are not SPPI and therefore FVPL
  - Convertible bonds/notes
  - Bonds with non-cumulative interest
  - Loans with inverse floating interest rate

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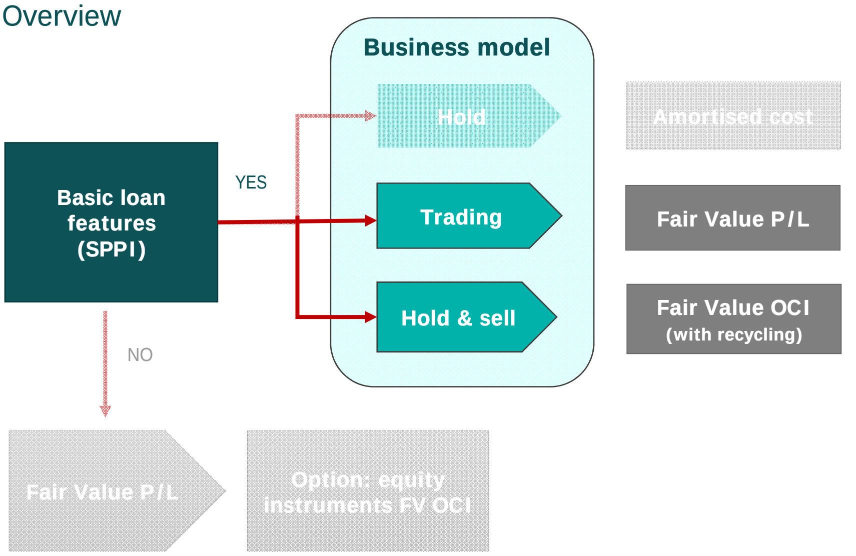
Financial Asset Classification

Overview



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Basic loan features (SPPI)

Business model

- Selling / trading
  - Are acquired for sale in the near term;
  - are part of a portfolio that are managed together and evidence of a recent actual pattern of short-term profit-taking;
  - Managed on a fair value basis
- Hold and trade
  - Collect cash flows
  - More than infrequent trading activities
  - Recycle to P/L on disposal

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Basic loan features (SPPI)

Business model - example

An entity holds an investment portfolio containing fixed-interest government and corporate bonds and other short-term deposits. The entity's intention is to preserve capital and generate an appropriate return to fund future activities and operations.

It's business model may be either:

1. Buy, hold to maturity, reinvest	Amortised cost
2. Actively trade to benefit from changes in bond prices	Fair value through P/L
3. Hold to collect interest and trade	Fair value through OCI

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Basic loan features (SPPI)

Business model – hold and trade

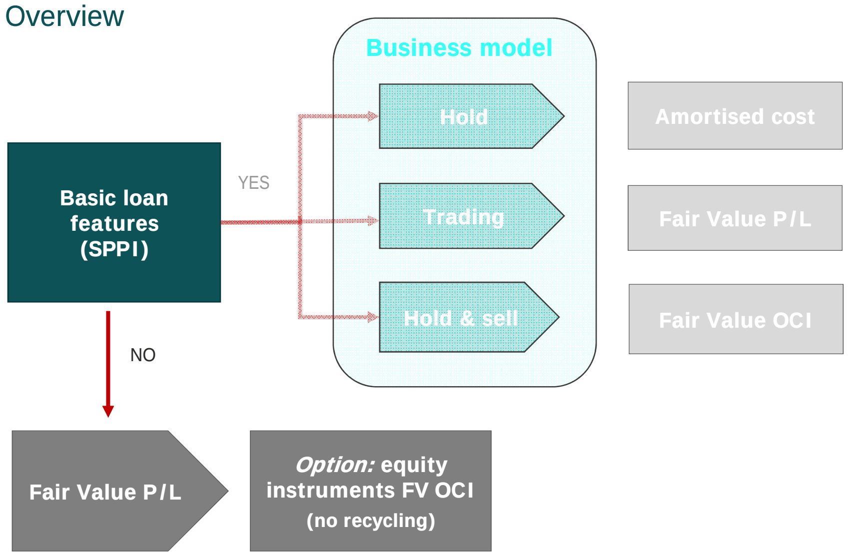
- Measure at fair value
- Apply impairment requirements
  - Impairment recognised in profit
- Other fair value changes recognised in OCI

Changes in carrying value caused by ...	Recognised in ...
Change in market interest rates	OCI
Impairment	Profit and loss

Financial Assets at Fair Value

Financial Asset Classification

Overview



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Financial Assets at Fair Value

- Any financial asset that
  - fails SPPI test
  - designated as FVTPL at initial recognition
  - managed on a fair value basis
- FV change recognised in profit and loss
  - Only exception **equity instruments** can be designated FVOCI
    - Only if not held for trading
    - Irrevocable election
    - On an instrument-by-instrument basis
    - No recycling to P/L
    - No separate impairment recognition
- AASB 139 exception to measure some unlisted investments at cost removed

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Financial Asset Classification

Summary

- Simple assets and operations unchanged
  - Trade receivables & some equity investments
- Business model test may affect some arrangements
  - Investment portfolios
- No FV measurement exclusion for some unlisted investments
- AASB 139 impairment test for AFS assets removed
  - No recycling of profit/loss on disposal of FVOCI equity instruments

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Impairment of financial assets

Impairment of Financial Assets

Approaches

1. Simplified approach
   - Trade receivables (AASB 15) and designated lease receivables
2. General approach
   - Most loans and debt securities
   - Long-term loans
   - Related party loans
3. Purchased or originated credit-impaired approach

- Expected loss model (AASB 9) vs incurred loss model (AASB 139)

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Impairment of Financial Assets

Simplified approach

- Always used for trade receivables
- Need to elect for lease receivables
- Recognition of lifetime expected loss
- Using supportable forward looking assumptions
- For example:

Ageing	Debtors $	Loss rate	Expected loss $ (assuming zero recovery)
<30 days past due	576,000	1.0%	5,760
31-60 days past due	325,000	2.0%	6,500
61-90 days past due	260,000	5.0%	13,000
> 90 days past due	85,000	7.5%	6,375
	$1,246,000		$31,635

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Impairment of Financial Assets

General approach

Recognise expected credit losses in two steps:

1. Arising from default events ‘that are possible’ within the next 12 months;
   - Based on probability weighted risk of default in the next 12 months
   - Reasonable and supportable forecast future conditions

2. For a significant increase in credit risk, lifetime expected loss
   - Rebuttable presumption: significant increase in credit risk if more than 30 days past due

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Impairment - example

12 month expected credit loss approach

Entity A originates a single 10 year amortising loan for $1 million. Entity A estimates that the loan has a probability of default (PD) of 1.0% over the next 12 months. At the reporting date (which is before payment on the loan is due), there has been no significant increase in credit risk or change in the PD since initial recognition. If the loan defaults Entity A determines that 30% of the gross carrying amount will be lost.

At the reporting date the loss allowance for the 12 month expected credit loss is $3,000 (1.0% × 30% × $1,000,000).

Implicit in that calculation is the 99.0% probability that there is no default and no loss.

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Impairment of Financial Assets

Implications

- Because 'expected credit loss' defined as weighted average of credit losses based on risk of default, unless that weighting is zero, there will be some allowance recognised
  - Not the actual cash flows expected to be lost
- For debt portfolio classified as FVOCI, need to separate impairment adjustments
  - Adjusts amounts recognised in OCI
- No separate impairment recognised for assets FVPL

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Reclassifications

Reclassifications

- Permitted only where a change in business model relating to that asset
- Reclassify prospectively
  - from start of the next reporting period after change in business model
- No retrospective restatement of amounts previously recognised

Reclassifications

From \ To	Amort Cost	FVTPL	FVOCI
Amort Cost		Remeasure to FV at reclassification date Recognise difference in profit	Remeasure to FV at reclassification date Recognise difference in OCI
FVPL	• FV at reclass'n date becomes new gross carrying value (deemed cost)		• Continues at FV • No restatement of Retained Earnings or OCI
FVOCI	• Cumulative OCI adjusted against asset (restated to amortised cost) • No effect on profit	• Continues at FV • Cumulative OCI balance reclassified from equity to profit at reclassification date	

Main differences to AASB 139

Category	Area	Change
Classification	Amortised cost classification	No concept of 'tainting' as with 'held-to-maturity' classification
	Four categories of financial assets under AASB 139 replaced	▪ More assets will be FVPL ▪ Use of FVOCI narrower than AFS
	Unlisted investments	Previous exception to measure at cost removed. Must be at FV
Impairment	Expected credit losses	Need to consider risk adjusted probability of default
	Impairment of equity investments	No separate P/L recognition

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Financial liabilities

Financial liabilities

Classification

Amortised cost

except for

Fair value through P/L

- Held for trading
- Managed and reported internally on a fair value basis
- Eliminates or reduces an accounting mismatch
- Financial guarantee contracts
- Loan commitments at below-market rates
- Contingent consideration for business combinations

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Hedge Accounting

Hedge accounting

- Accounting for risk management activities
- Only applies to risks that could affect profit or loss
  - Exception for equity investments at FVOCI
  - intra-group transactions that don't affect group P/L
- Three types of hedges
  - cash flow hedges
  - fair value hedges
  - hedges of net investments in foreign operations

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Hedge accounting

- Identify the risk management strategy and objectives
  - still need documentation
- Hedge effectiveness
  - prospective test only, removes retrospective tests
  - quantitative 80-125% test removed
  - economic relationship test
- Hedging risk components
- Hedging groups and net positions
  - Can designate multiple hedges against a hedged item
- All qualifying criteria need to be met to initially adopt

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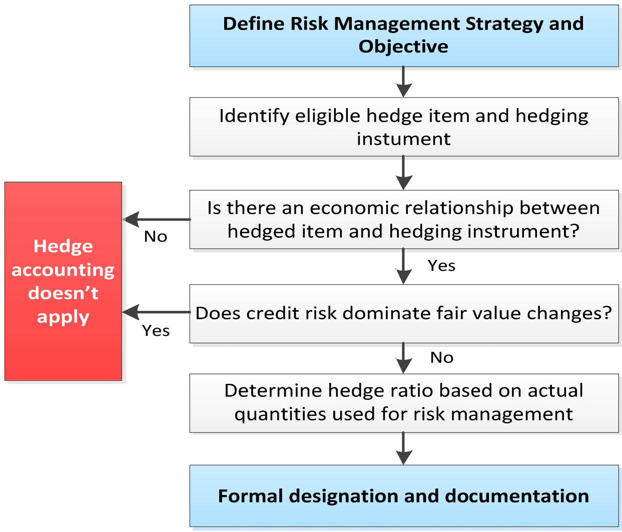
Hedge accounting

Overview



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Risk Management Strategy and Objective

Risk Management Strategy

- Identifies the risks at entity level
- How the entity responds to those risks

Strategy for managing interest rate exposure is to target between 30%-40% fixed rate debt

Risk Management Objective

- Particular instrument to hedge the particular identified risk

Execution of the strategy through specific instruments eg, $50m fixed rate swap

Use of individual instruments/objective may change without the risk management strategy changing

- Hedging discontinued when risk management objective no longer met or economic relationship broken

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Transition

Transition – if not currently applying AASB 9

Classification and impairment

- Business model assessment must be based on the facts and circumstances that exist at the date of initial application
- Cash flow characteristics based on those that existed at the date of initial recognition of the asset
- Resulting classification and measurement is applied retrospectively
  - ie, amortised cost, FVOCI, FVPL
- Limited exceptions to restating comparatives for classification, measurement and impairment
  - Apply from start of period of first adoption
- Must recognise FV of investments previously carried at cost
- Significant transitional disclosures
  - Including changes in designations and measurements

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In summary...

Engage and start the assessment and diagnostic process

- Begin assessment and analysis of current arrangements
- Assess potential changes in measurement and classification
- Expected credit loss approach
- Consider the judgements and assumptions
  - Implications on internal systems and data capture
- Investments previously carried at cost
- Changes to hedge accounting and effectiveness testing
- Consider transitional provisions & choices

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