On your marks: are you ready for AASB 9?

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On 1 July 2018 two new accounting standards will become effective for large parts of corporate Australia – AASB 15: Revenue from contracts with customers, and AASB 9: Financial instruments.

This publication focuses on AASB 9 and highlights a number of important considerations for entities at the date of initial application (DIA) and their first year reporting under this new standard.
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Get ready for the DIA, make your AASB 9 elections today!

Many organisations have been hard at work on their AASB 9 implementation projects for some time however it is now time to put that planning into action.

There are a number of important actions entities will need to take as at 1 July 2018, the date of initial application (DIA) of AASB 9 for entities with a 30 June year end.

The decisions that need to be made relate to hedge accounting, the insurer exemption, classification and measurement, impairment, transition elections and disclosure. These have been summarized in the list below.

**Hedge accounting**

The key decisions that need to be made as at the DIA are:

1. Entities need to decide whether they will adopt the new hedge accounting model under AASB 9 or continue hedge accounting under AASB 139, which is permissible until the IASB completes its project on accounting for dynamic risk management.

   The new hedge accounting rules provide greater flexibility and more opportunities, particularly for corporates, with few (if any) disincentives to change.

2. Entities need to actively make a decision with respect to which hedge accounting model they apply, it is not automatic.

   The decision should be formally documented and approved by the entities usual policy governance processes.

3. For entities wishing to apply the new AASB 9 hedge accounting rules, they will first need to update their old hedge documentation or risk non-compliance with the standard.

   For example, AASB 9 requires entities to identify expected sources of ineffectiveness in their hedge documentation. If your entity does not do this, you might be unable to apply hedge accounting until the documentation is compliant.

   For those seeking to take advantage of new provisions, such as the new treatment for the costs of hedging, entities will need to decide whether this is to be done retrospectively or prospectively.

   In addition to the above, for those entities adopting the AASB 9 hedge accounting model, have you:
   - Identified and documented any new hedges that you intend to designate under the new standard? And/or;
   - Decided to designate any qualifying credit exposures at FVTPL?

**Insurer exemption**

If you are an insurer, have you elected the temporary exemption from AASB 9?

**Classification and measurement, including impairment**

1. Have you documented your assessment of the appropriate business models in which your financial assets are held based on facts and circumstances at the DIA?

2. Have you determined whether the contractual cash flows on your financial assets represent solely payments of principal and interest on the principal amount outstanding based on fact and circumstances at initial recognition of the instrument?

3. Entities will need to measure all equity investments (and related derivatives) at fair value as at the DIA. The cost exemption afforded under AASB 139 is no longer available.
4. An adjustment may be required to the carrying amount of financial assets or liabilities that were subject to a non-substantial modification in prior periods.

5. For financial instruments in scope of the impairment requirements, have you determined whether there has been a significant increase in credit risk since initial recognition? If not possible without undue cost or effort then you must measure and record impairment based on lifetime expected credit losses.

**Elections**

1. Have you elected to present changes in fair value in OCI for an investment in an equity instrument that is not held for trading?

   The election is made on an instrument-by-instrument basis and is irrevocable.

   Note that investments in units issued by funds or trusts that meet the definition of a financial liability but are classified as equity by the fund or trust are not eligible for this election and therefore would be measured at FVTPL.

2. Consider whether any FVTPL designations for financial assets and liabilities will be made or revoked upon transition to AASB 9.

3. Are there any own-use contracts that you wish to designate as at FVTPL?

**Disclosures**

1. Have you decided what transitional disclosure you will be required to make?

2. Are you electing to restate comparative information?

   Comparatives relating to classification and measurement (including impairment) may be restated so long as it is possible without the use of hindsight.

3. For entities that designate the intrinsic value of options as a hedging instrument, the comparatives will need to be restated for the cost of hedging requirements.

   Retrospective application is permitted, but not required, in respect of the forward element of forward contracts and foreign currency basis spreads.
FVOCI elections - the devil is in the detail

Entities have a choice on initial recognition to elect to present in OCI changes in the fair value of an investment in an equity instrument that is not held for trading and that is not contingent consideration recognized by an acquirer in a business combination.

As noted above the election is irrevocable and can be made on an instrument-by-instrument basis.

In determining whether an instrument is eligible for the election the investor needs to understand whether it meets the definition of an equity instrument from the perspective of the issuer (the investee).

If it is not possible for the holder of a financial asset to determine whether the particular investment that it holds meets the definition of an equity instrument of the issuer then it would be precluded from applying the FVOCI election to that investment.

Puttable instruments

The option to present changes in fair value in OCI is limited to equity instruments defined as such by AASB 132 and therefore does not apply to instruments defined as financial liabilities but classified as equity by the issuer.

For example, puttable instruments issued by funds or managed investment schemes often meet the definition of a liability but are classified as equity by the issuer and as such would not be eligible for the FVOCI election.

Derivatives

An entity may invest in a derivative that meets the definition of an equity instrument of the issuer because it satisfies the fixed-for-fixed criterion in AASB 132. These instruments are not eligible for the FVOCI election because derivative instruments are within the definition of held for trading in AASB 9.

Compound instruments

A holder of an investment in a compound instrument cannot elect to present changes in fair value of that instrument in OCI. This is because the instrument is not an equity instrument of the issuer in its entirety (it comprises a liability and equity component).

Convertible bonds

Upon conversion of a bond into equity instruments of the issuer, the holder may elect to present changes in fair value in OCI (assuming the equity instruments are not held for trading). This is because the equity instruments are considered a new asset, separate from the initial investment in the bond.

Loss of significant influence

An entity may lose significant influence over an associate but retain an investment in an equity instrument that is in the scope of AASB 9. This retained interest will need to be measured at fair value and is eligible for the election to present changes in fair value in OCI, so long as all the conditions are met.
Fair value for all - cost exception for equity instruments no longer allowed

Does your entity currently make use of the AASB 139 exception allowing for the measurement of certain unquoted equity instruments (and associated derivatives) at cost?

On transition to AASB 9, such investments (other than interests in subsidiaries, associates or joint ventures) are required to be measured at fair value.

Equity investments can no longer be held at cost and the requirement is to be applied prospectively from the DIA (which means organisations cannot restate comparatives for this change).

Along with the measurement change, organisations need to consider the extensive disclosures on recurring level 3 fair value measurements which will include many unquoted equity instruments.
A practical guide to provisioning

As organisations approach their DIA the drive to find practical solutions to the implementation of AASB 9 is clear. An example is in relation to assessing expected credit losses on trade receivables. One practical solution available to entities under AASB 9 is the use of a provision matrix to measure impairment losses on trade receivables.

Let’s consider an example:

Example – Australian Corporate (A Limited) Trade Receivable Portfolio

An Australian company, A Limited, manufactures and sells consumer products and has a portfolio of trade receivables of **AUD 152 million** at its year end reporting date of 31 December 2018.

- **Note:** As the DIA for an entity with a 31 December year-end is 1 January 2018, our data set has been sourced up to December 2017.

A Limited has a large number of small customers. Past experience shows that loss patterns on trade receivables differ based on the region in which its customers are located. In addition, receivables that have been outstanding for more than **120 days** have historically been uncollectable and result in a loss equal to the outstanding balance being incurred (irrespective of the region).

Based on A Limited’s historical experience, it segments its receivables based on the geographical region to which the customer belongs – accordingly a provision matrix is prepared for each geographical region. Let’s consider the Northern region.

The provision matrix example below requires complete and reliable data spanning a sufficient period of time. Historical loss data is used to provide support for formulating assumptions. For example, the key assumption in our illustration being expectations of 100% loss at 120 days past due.

Appropriate consideration should be applied in the application of judgment when incorporating forward-looking information into impairment measurement. It may be appropriate to base this on the historical relationship between credit losses and exogenous factors.

In the case of low volume portfolios, the roll rate approach may not be suitable; smoothing techniques or external benchmarking are commonly observed solutions in this instance.
Table 1: Historical ageing of trade receivables held by A Limited

Using the historical ageing data in Table 1, A Limited will need to calculate the ‘roll rates’ applicable to each ageing bracket. The roll rate indicates the percentage of trade receivables in an ageing bracket that have not been collected during the month and have therefore moved into the next ageing bracket.

Example ‘roll-rate’ calculation:

Let’s first consider the data in the blue shaded cells above:

- AUD 75.46 million of trade debtors were not due at December 2015;
- AUD 46.10 million were not collected in the month and moved into the 0-30 days ageing bracket at January 2016, therefore;
- As can be seen in the blue shaded cell in Table 2 below, the ‘roll rate’ for the 0-30 days ageing bracket at January 2016 is 61.1% which is calculated by dividing the value of trade receivables that were 0-30 days past due in Jan-16 by the value of trade receivables that were not due in Dec-15 being the month prior, i.e. 46.10 / 75.46 * 100.

Now let’s consider the purple shaded cells in Table 1 above:

- AUD 77.79 million of trade debtors were not due at January 2016;
- AUD 40.34 million were not collected in the month and moved into the 0-30 days ageing bracket at February 2016, therefore;
- The ‘roll rate’ for the 0-30 days ageing bracket at February 2016 (as shown in the purple shaded cell in Table 2 below) is 51.9% which is calculated by dividing 40.34 by 77.79.
Here is one final example to illustrate the calculation using the green shaded cells from Table 1:

- AUD 44.72 million of trade debtors were in the 0-30 Days ageing bracket at December 2015;
- AUD 8.64 million were not collected in the month and moved into the 30-60 days ageing bracket at January 2016, therefore;
- The ‘roll rate’ for the 30-60 days ageing bracket at January 2016 (as shown in the green shaded cell in Table 2 below) is 19.3% calculated by dividing 8.64 by 44.72.

Table 2: Computation of ‘roll rate’ based on historical ageing of trade receivable

A Limited has determined the roll rates for all ageing brackets by repeating the calculations illustrated above.

Subsequently, A Limited has determined the historical average roll rates for all ageing brackets as shown in Table 2.

<table>
<thead>
<tr>
<th>Reporting Date</th>
<th>0 - 30</th>
<th>30 - 60</th>
<th>60 - 90</th>
<th>90 - 120</th>
<th>120+</th>
</tr>
</thead>
<tbody>
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<td>Dec-17</td>
<td>51.9%</td>
<td>38.5%</td>
<td>33.3%</td>
<td>50.0%</td>
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<td>69.6%</td>
<td>31.0%</td>
<td>37.7%</td>
<td>25.0%</td>
<td>50.0%</td>
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<tr>
<td>Oct-17</td>
<td>48.3%</td>
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<tr>
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<td>32.7%</td>
<td>33.3%</td>
<td>46.7%</td>
</tr>
<tr>
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<td>38.3%</td>
<td>23.1%</td>
<td>32.6%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Jul-17</td>
<td>44.0%</td>
<td>24.5%</td>
<td>37.4%</td>
<td>40.0%</td>
<td>20.0%</td>
</tr>
<tr>
<td>Jun-17</td>
<td>56.4%</td>
<td>25.6%</td>
<td>41.7%</td>
<td>57.1%</td>
<td>46.7%</td>
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<tr>
<td>May-17</td>
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<td>21.4%</td>
<td>38.9%</td>
<td>33.3%</td>
<td>45.5%</td>
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<tr>
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<td>38.6%</td>
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<td>19.1%</td>
<td>51.8%</td>
<td>22.2%</td>
<td>15.0%</td>
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<tr>
<td>Dec-16</td>
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<tr>
<td>Sep-16</td>
<td>42.1%</td>
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<td>Aug-16</td>
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<td>Jul-16</td>
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<td>Jun-16</td>
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<tr>
<td>May-16</td>
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<td>15.3%</td>
<td>50.0%</td>
<td>38.6%</td>
<td>30.0%</td>
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<tr>
<td>Apr-16</td>
<td>69.4%</td>
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<td>Mar-16</td>
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<tr>
<td>Feb-16</td>
<td>51.9%</td>
<td>38.5%</td>
<td>33.3%</td>
<td>50.0%</td>
<td>50.0%</td>
</tr>
<tr>
<td>Jan-16</td>
<td>61.1%</td>
<td>19.3%</td>
<td>45.8%</td>
<td>25.8%</td>
<td>103.1%</td>
</tr>
</tbody>
</table>

Historical average ‘roll-rates’

<table>
<thead>
<tr>
<th>0 - 30</th>
<th>30 - 60</th>
<th>60 - 90</th>
<th>90 - 120</th>
<th>120+</th>
</tr>
</thead>
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<tr>
<td>59.3%</td>
<td>29.0%</td>
<td>36.4%</td>
<td>39.8%</td>
<td>38.0%</td>
</tr>
</tbody>
</table>
Example historical average roll rate calculation (by ageing bracket)

The historical average roll rate for assets that move from “not due” into the “0 – 30 days past due” bracket is 59.3% and calculated as the simple average of the roll rates for each month shown in the “0 – 30” column in Table 2 above.

- Average of 0-30 Days ageing bracket roll-rates =

\[ \frac{61.1\% + 51.9\% + 55.8\% + 69.4\% + 77.8\% + 60.8\% + 56.4\% + 44.0\% + 42.1\% + 79.6\% + 48.3\% + 69.6\% + 51.9\% + 55.8\% + 69.4\% + 77.8\% + 60.8\% + 56.4\% + 44.0\% + 42.1\% + 79.6\% + 48.3\% + 69.6\% + 51.9\%}{24} = 59.3\% \]

The computation of the credit loss rate and the expected credit loss amount is illustrated in Table 3.

In our case, A Limited has determined, based on historical experience, that it never collects any receivables that are greater than 120 day past due. Therefore, a credit loss rate of 100% is applied against any balance in the More than 120 days past due ageing bracket. Such assumptions will differ between entities and should be based on their specific facts and circumstances.

**Table 3: Provision for expected credit loss calculation (AUD millions)**

The average roll rates computed in Table 2 are used to determine the “Credit loss rate” in Table 3. This is determined by multiplying the average roll rates for the applicable ageing brackets.

**Example credit loss rate calculation**

Example calculation of credit loss rate for the 0 – 30 days past due ageing bracket:

Of the AUD 86 million receivables that are currently not due:

- **59.3 per cent** (identified by the yellow square in both Table 2 and Table 3) are expected to move into the 0 – 30 days past due bracket

- **29.0 per cent** of the receivables in the 0-30 day bracket are expected to move into the 30 – 60 days past due bracket, and so on.

Expressed as an equation, the credit loss rate for receivables that are not due looks like this:

\[ 59.3\% \times 29.0\% \times 36.4\% \times 39.9\% \times 38.0\% = 0.9\% \] (identified by the green square in Table 3 above)

We can interpret this result by saying that A Limited expects to suffer losses equal to 0.9% of all debtors that are not due at the balance date (i.e. current debtors).

Don’t forget, the credit loss rate is adjusted by a forward-looking estimate. In our case, this includes the probability of a worsening domestic economic environment in the northern region which results in an adjustment to the credit loss rate upwards by 5% for each ageing bracket and is represented by the “Adjusted credit loss rate” column in Table 3.

Using this method, the total expected credit loss on the portfolio of trade receivables as at 1 January 2018 (the DIA for an entity with a December year-end) is measured at AUD 4.4 million.
Key points to remember

A provision matrix generally has the following features:

- It is based on historical credit loss experience, adjusted as appropriate to reflect current conditions and reasonable and supportable forecasts of future economic conditions;
- It specifies provision rates based on the number of days that a trade receivable is past due; and
- Appropriate grouping or segmentation may be used if the historical experience shows different loss patterns for different customer segments, e.g. geographical regions, customer ratings, product type, etc.
Disclosures – considerations for interim and first annual reporting periods

Although AASB 9 will have the most impact on entities whose primary business is lending, those entities not involved in lending do not escape the impacts of the new standard, in particular, the new disclosure requirements contained in AASB 7 Financial Instruments: Disclosures.

The new standard has a host of disclosures required on transition, particularly around classification and measurement. It also introduces increased ongoing disclosures relating primarily to credit risk and hedge accounting.

In this section we take you through a number of frequently asked questions and answers relating to the new disclosure requirements.

What does an entity need to disclose in the first interim report after the DIA?

Depending on the significance of the transition to AASB 9, entities should consider which of the transitional disclosures should be included in interim reports, to enable users to understand the changes from the last annual report and leave ‘no surprises’ for the first full annual report after the DIA.

What are some of the key disclosures required in the first year of adoption?

AASB 7 contains extensive transitional disclosure requirements, some of these include:

For each class of financial assets and financial liabilities:

- Original measurement category and carrying amount determined under AASB 139 and the new measurement category and carrying amount determined under AASB 9;
- Amount of any financial assets or liabilities in the statement of financial position previously designated at FVTPL that are no longer so designated.

For financial assets and financial liabilities reclassified to amortised cost and, in the case of financial assets, reclassified from FVTPL to FVOCI:

- The fair value of the financial assets or financial liabilities at the end of the reporting period; and
- The fair value gain or loss that would have been recognised in profit or loss or OCI during the reporting period if reclassification had not occurred.

Entities should also keep in mind that the use of certain transitional practical expedients in AASB 9 also carry associated disclosure requirements.

What about ongoing disclosures?

Credit risk

Not surprisingly, the purpose of the new ongoing requirements regarding credit risk is to provide quantitative and qualitative information to make it clear to users how the expected loss requirements were applied. This includes explanations for the methods, assumptions and other information used by management.

Hedge accounting

With regards to hedge accounting, whether the new general hedging model under AASB 9 is adopted or not, the new ongoing disclosure requirements in AASB 7 cannot be deferred. Under the revised AASB 7 entities are required to disclose, in a tabular format, specific information about both hedging instruments and hedged items and the impact on the profit and loss statement and the balance sheet.

Classification and measurement

Other ongoing disclosures also exist such as where an entity reclassifies any financial assets due to a change in business model. Some of these disclosures will continue so long as the reclassified assets are still on the balance sheet.
Contact us

For more information on this publication please contact:

**Patricia Stebbens**  
Partner  
+61 3 9288 6261  
pstebbens@kpmg.com.au

**Mohamad Shahin**  
Senior Manager  
+61 3 9838 4866  
mshahin@kpmg.com.au

**Aaron Laurie**  
Senior Manager  
+61 3 9288 5524  
alaurie@kpmg.com.au