Australian Government

Department of Finance

FINANCE POSITION PAPER

2017-18 No. 2

Implementation Options for AASB 9 *Financial Instruments*

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Contents

Purpose

The purpose of this Position Paper (the Paper) is to provide the Department of Finance's (Finance) position on selected options and application guidance to the implementation of Australian Accounting Standards Board (AASB) 9 *Financial Instruments* (AASB 9 or this standard) in the whole of government (WoG) and general government sector (GGS), to ensure a smooth transition to the new standard.

Agreement on these options will serve to provide clarity to Commonwealth entities and to their audit teams when reporting financial instruments for initial application in 2018-19.

Scope

Accounting standards issued by the AASB apply to Commonwealth entities under Section 42(2) (a) and to the Commonwealth Consolidated Financial Statements (CFS) under Section 48(2) (a) of the *Public Governance, Performance and Accountability Act 2013* (PGPA Act).

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. AASB 9 applies for reporting periods beginning on or after 1 January 2018 and replaces AASB 139 *Financial Instruments: Recognition and Measurement* (AASB 139). AASB 9 applies, with some exceptions[1], to all types of financial instruments and introduces a new classification model for financial assets that is more principles-based than the previous requirements in AASB 139.

This paper reviews the transition options under AASB 9 and the ongoing application of the standard. Options have been selected based on their compliance with AASB 1049 *Whole of Government and General Government Sector Financial Reporting* (AASB 1049), the need for consistency across Commonwealth entities, and an assessment of the costs of implementing particular options for preparers against their benefits to financial statement users.

This paper does not consider the option to measure a financial instruments at fair value where risk is managed using a credit derivative (paragraph 6.7.1 of AASB 9) as it will not be relevant to most entities. The transitional option of paragraph 7.2.14A on contracts to buy and sell non-financial assets is not covered as Finance will need to consider existing designation for these types arrangements. If either of these options applies to you, please contact Finance Accounting Policy Team at accountingpolicy@finance.gov.au.

Relevant Accounting Pronouncements

The following documents are relevant:

- AASB 9 *Financial Instruments*;
- AASB 132 *Financial Instruments: Presentation*;
- AASB 139 *Financial Instruments*: *Recognition and Measurement*;
- AASB 7 *Financial Instruments: Disclosure*;

[1] AASB 9, paragraph 2.1

- AASB 2016-8 *Amendments to Australian Accounting Standards – Australian Implementation Guidance for Not-for-Profit Entities (AASB 9 & AASB 15)*;
- AASB 1049 *Whole of Government and General Government Sector Financial Reporting*;
- AASB 1023 *General Insurance Contracts*;
- AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*;
- AASB 10 *Consolidation Financial Statements*;
- AASB 15 *Revenue from Contracts with Customers*; and
- RMG 112 *Identification of general insurance contracts for accounting purposes*.

Transition

General Transition Requirements

AASB 9 must be applied retrospectively in accordance with AASB 108. This standard shall not be applied to items that have already been derecognised at the date of initial application (DIA). The DIA of AASB 9 for a 30 June year-end Commonwealth entity is 1 July 2018.

AASB 9 does not require restatement of the prior period except in limited circumstances related to hedge accounting[2].

The following assessments must be performed on the DIA for the financial instruments that the entity already owns:

- Assessing the objective of the business model the financial asset is held within;
- Assessing whether the financial asset meets the solely payments of principal and interest (SPPI) requirement;
- Determining the fair value of a financial instrument when it is impracticable to apply the effective interest rate (EIR) method retrospectively;
- Designating or revoking a designation to measure a financial instrument at Fair Value through Profit & Loss (FVTPL) if it will eliminate or significantly reduce an accounting mismatch;
- Assessing whether an accounting mismatch would be created or enlarged by presenting the effects of changes in a financial liability's credit risk in Other Comprehensive Income (OCI);
- Designating to whether to measure subsequent changes in the fair value of an equity instrument in OCI;
- Determining the fair value of an equity investment or derivative linked to an equity instrument that was previously accounted for at cost under AASB 139; and
- Determining whether there has been a significant increase in credit risk since initial recognition.

[2] AASB 9, paragraph 7.2.15

Reclassification of Financial Instruments[3]

For financial assets, reclassification is required between FVTPL, Fair Value through Other Comprehensive Income (FVOCI) and amortised cost, if and only if the entity's business model objective for its financial assets changes so its previous model assessment would no longer apply.

'When, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets in accordance with paragraphs 4.1.1–4.1.4. See paragraphs 5.6.1–5.6.7, B4.4.1–B4.4.3 and B5.6.1–B5.6.2 for additional guidance on reclassifying financial assets.' [4]

The Australian Government controlled entities are generally unable to change their business model as these have been determined by the PGPA Act and enabling legislation. Entities should contact Finance if they believe their business model has changed.

Note that *'An entity shall not reclassify any financial liability.'*[5]

Transition Options for Commonwealth Entities

Option 1: Date of first adoption

All Commonwealth entities with a 30 June year-end will be required to apply AASB 9 from 1 July 2018. This means the standard will be applied to the monthly statements from July 2018 and included in the 2018-19 Budget year.

FINANCE POSITION 1

AASB 9 must be applied for financial periods beginning on or after 1 January 2018. For most entities this will be financial year commencing 1 July 2018. Early adoption is not permitted.

Option 2: Comparatives need not be restated

AASB 9 requires retrospective application:

'An entity shall apply this Standard retrospectively, in accordance with AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors…This Standard shall not be applied to items that have already been derecognised at the date of initial application.' [6]

Prior periods need not be restated and may only be restated if this can be done without the benefit of hindsight:

[3] AASB 9, paragraph 4.4
[4] AASB 9, paragraph 4.4.1
[5] AASB 9, paragraph 4.4.2
[6] AASB 9, paragraph 7.2.1

'Despite the requirement in paragraph 7.2.1, an entity that adopts the classification and measurement requirements of this Standard (which include the requirements related to amortised cost measurement for financial assets and impairment in Sections 5.4 and 5.5) shall provide the disclosures set out in paragraphs 42L–42O of AASB 7 but need not restate prior periods. The entity may restate prior periods if, and only if, it is possible without the use of hindsight.' [7]

'…If an entity does not restate prior periods, the entity shall recognise any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application.' [8]

It would be impractical to expect all Commonwealth entities to have maintained the records necessary, and to have the time and resources, to restate prior periods. There is no obvious benefit to users from preparing the comparative 2017-18 year under AASB 9. Accordingly, comparatives should not be restated. Any difference between the previous carrying amounts and the new carrying amounts under AASB 9 at the DIA must be recognised in **opening retained earnings**, at the beginning of the reporting period that includes the DIA.

FINANCE POSITION 2

Entities should not restate comparatives.

Option 3: Administered investments

AASB 9 requires that *'all investments in equity instruments and contracts on those instruments must be measured at fair value'*[9]. For equity investments, amortised cost will not be applicable and the fair value category must be applied. Paragraph B5.2.3 acknowledges that:

'Cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.'

Capital contributions to public corporations (that are not loans) are classified fully as equity if the investment is forecast to provide a real return (i.e. after inflation) to the government[10]. Under AASB 139, equity investments in public corporations (administered investments) are classified as available-for-sale.

AASB 9 permits entities to make an irrevocable election to present gains and losses on investments in equity instruments in OCI. This reduces volatility within net profit and eliminates the perceived inconsistencies in accounting for available-for-sale financial assets under AASB 139.

'*At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the*

[7] AASB 9, paragraph 7.2.15
[8] AASB 9, paragraph 7.2.15
[9] AASB 9, paragraph B5.2.3
[10] The *Charter of Budget Honesty – Policy Costing Guidelines* (https://www.finance.gov.au/publications/charter-of-budget-honesty/) describe the characteristics of equity investment. Where funding does not meet the equity criterion, it may be classified as an expense.

scope of this Standard that is neither held for trading nor contingent consideration recognised by an acquirer in a business combination to which AASB 3 applies.'[11]

The accounting treatments for the equity investments classified at FVOCI are:

- fair value changes are recognised in OCI;
- dividends are recognised in P&L[12]; and
- on disposal of the investment, the cumulative change in fair value is required to remain in OCI and is not recycled to P&L. However, entities have the ability to transfer amounts to another reserves within equity, such as retained earnings[13].

Commonwealth entities hold administered investments in Government Business Enterprises and other investments on behalf of Government. As noted above, these assets are currently classified as 'available for sale' with valuation movements recognised in OCI.

Finance does not see any benefit in reflecting short-term fluctuations in value in the operating result and will mandate classification at FVOCI. This is consistent with the treatment of these assets under AASB 139.

Finance would not expect this election to be made for other equity investments. Note that AASB 9 requires all equity investments to be measured at fair value.

FINANCE POSITION 3

All administered investments and international subscriptions (refer Finance Position 6) should be classified as FVOCI. Entities should contact Finance before making this election for other equity instruments.

Option 4: Financial assets at FVTPL

AASB 9 is more prescriptive in the classification of financial instruments than AASB 139. In most cases, AASB 9 requires financial assets to be categorised as at amortised cost, FVTPL or FVOCI according to their nature and purpose[14]. AASB 9 allows election of a category in two circumstances:

- classification of equity instruments at FVOCI (Finance Position 3); and
- designation at FVPL where this eliminates an accounting mismatch.

[11] AASB 9, paragraph 5.7.5
[12] AASB 9, paragraph 5.7.6
[13] AASB 9, paragraph B5.7.1
[14] AASB 9, paragraph 4.1.1

'Despite paragraphs 4.1.1–4.1.4, an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases'[15]

Where an entity identifies an accounting mismatch, this should be discussed with Finance to ensure consistent accounting policies are followed.

FINANCE POSITION 4

Entities should discuss accounting mismatches with Finance prior to classifying a financial asset or liability.

Option 5: Hedge accounting[16]

The hedge accounting requirements in AASB 9 are optional. If certain eligibility and qualification criteria are met, hedge accounting allows an entity to reflect risk management activities in the financial statements by matching gains and losses on financial hedging instruments with losses or gains on the risk exposures they hedge. AASB 9 allows an entity to '*apply the hedge accounting requirements in AASB 139 instead of those in this Standard.'*[17]

It is Australian Government policy that GGS entities generally do not act to reduce the risk, such as foreign exchange risk that they would otherwise face in the course of their business arrangements. Unless exempted by the Finance Minister, entities are not permitted to undertake any form of hedging.

The changes to hedge accounting are not expected to materially impact the Commonwealth entities as only a few entities engage in hedging. For the entities who are **currently holding hedged instruments**, they should adopt the new hedging accounting of AASB 9.

The new hedge accounting model is more flexible than that currently applying under AASB 139, while introducing requirements on rebalancing and prohibiting voluntary termination. Finance considers this model conceptually preferable and proposes mandatory application.

FINANCE POSITION 5

Commonwealth entities holding hedging instruments should adopt the new hedging accounting of AASB 9. The alternative of continuing to use AASB 139 will not be permitted.

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[15] AASB 9, paragraph 4.1.5
[16] AASB 9, chapter 6
[17] AASB 9, paragraph 6.1.3

Option 6: Impact of 2015 ABS GFS Manual on IDA/IDF subscriptions

The new ABS GFS requirements will impact on Australian Government operations effective for reporting periods from 2017-18.

The ABS GFS Manual has been updated to incorporate the changes sought by the International Monetary Fund (IMF) as outlined in its Government Finance Statistics Manual 2014 (IMF GFSM 2014). The changes may impact upon the classification of certain items and will change the reconciliation to GFS measures.

The 2015 ABS GFS Manual will change the treatment of subscriptions to the International Development Association (IDA) and the Asian Development Fund (ADF) (both are managed by the Department of Foreign Affairs and Trade on behalf of the Australian Government). For the 2017-18 financial statements, these subscriptions will be classified as **equity investments** instead of advances paid, and measured on a fair value basis (consistent with the CFS) instead of nominal basis.

Administered equity investments should be valued at FVOCI at DIA under AASB 9, as it reduces volatility within net profit and eliminates the perceived inconsistencies in accounting for available-for-sale financial assets under AASB 139. To meet the requirements for GFS harmonisation and for consistency with the treatment of other equity investments, Finance will mandate these be classified as FVOCI.

FINANCE POSITION 6

The subscriptions to the IDA and ADF will be classified as equity investments (Available-for-sale) for 2017-18 financial statements, and re-classified at FVOCI once AASB 9 applies in accordance with the new ABS GFS requirements.

Option 7: Financial guarantees as insurance contracts

If an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts, it may elect irrevocably to apply either AASB 9 or AASB 1023 *General Insurance Contracts.*[18] Entities should continue to apply the decision tree of RMG 112 *Identification of general insurance contracts for accounting purposes*. This will usually result in the continued application of AASB 1023.

FINANCE POSITION 7

Entities should continue to apply RMG 112. In most cases this will result in the application of AASB 1023. Note that this issue would be relevant only for a very small number of entities.

[18] AASB 9, paragraph 2.1(e)

Option 8: Application of the simplified approach for lease receivables, trade receivables and contract assets

AASB 9 requires entities to apply a simplified approach to trade receivables and contract assets (created under AASB 15 *Revenue from contracts with customers*) without a significant financing component. AASB 9 also permits the simplified approach for:

- lease receivables; and
- trade receivables and contract assets with significant financing activities.

'Despite paragraphs 5.5.3 and 5.5.5, an entity shall always measure the loss allowance at an amount equal to lifetime expected credit losses for:

> *(a) trade receivables or contract assets that result from transactions that are within the scope of AASB 15, and that:*
>
> > *(i) do not contain a significant financing component in accordance with AASB 15 (or when the entity applies the practical expedient in accordance with paragraph 63 of AASB 15); or*
> >
> > *(ii) contain a significant financing component in accordance with AASB 15, if the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses. That accounting policy shall be applied to all such trade receivables or contract assets but may be applied separately to trade receivables and contract assets.*
>
> *(b) lease receivables that result from transactions that are within the scope of AASB 117, if the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses. That accounting policy shall be applied to all lease receivables but may be applied separately to finance and operating lease receivables.*[19]

AASB 9 requires consistency in the optional application of the simplified approach. Application of the full expected credit loss model to lease receivables and trade receivables with a significant financing component would be costly to implement for no discernible benefit. Accordingly, Finance will mandate application of the simplified approach for all lease receivables, trade receivables with a significant financing component and contract assets with a significant financing component.

FINANCE POSITION 8

Entities should apply the simplified approach where available.

Option 9: Designation of financial liabilities at fair value

Accounting for financial liabilities is similar to AASB 139. AASB 9 allows designation of a financial liability at fair value:

[19] AASB 9, paragraph 5.5.15

'An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss when permitted by paragraph 4.3.5, or when doing so results in more relevant information…'[20]

FINANCE POSITION 9

Entities should continue with their existing classification for the financial liability.

[20] AASB 9, paragraph 4.2.2

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