

PBE IFRS 9

The new PBE Standard on
financial instruments

December 2017



Building a better
working world

Introduction

In both the public sector and the not-for-profit sector, most public benefit entities (PBEs) hold some type of financial instrument. Financial instruments include contractual receivables and payables¹, loans to/from other entities, shares or units held in other entities, bonds and derivatives. Therefore, the requirements on accounting for and reporting of financial instruments is likely to impact most PBEs. The changes to PBE Standards arising from PBE IFRS 9 *Financial Instruments* (PBE IFRS 9), issued in January 2017, are significant in some areas, and PBEs will need to ensure they are prepared for the implementation of the new standard.

Due to the New Zealand Treasury's decision to adopt this standard early, all government departments and those Crown entities and public sector PBEs that are part of the New Zealand Government reporting entity will need to apply PBE IFRS 9 in the year beginning 1 July 2018, if they fall into Tier 1 or Tier 2 of the PBE accounting standards framework.

For all other public sector PBEs in Tier 1 and Tier 2, and for all not-for-profit PBEs (including charities) in Tier 1 and Tier 2, PBE IFRS 9 must be applied for periods beginning on or after 1 January 2021, with early application permitted.

PBE IFRS 9 aligns the financial instruments accounting requirements for PBEs with the requirements of the new for-profit standard on financial instruments, NZ IFRS 9.

Key changes introduced by PBE IFRS 9 are:

- ▶ A new classification model for financial assets.
- ▶ A new, more forward-looking impairment model for financial assets, which requires impairment to be recognised based on expected (rather than incurred) credit losses.
- ▶ A new hedge accounting model that is less rules-based and more flexible, under which hedge accounting can be applied to a wider range of risk management strategies.

This publication aims to assist PBEs with preparing to apply PBE IFRS 9.

¹ Financial instruments include receivables and payables that arise from contractual rights and obligations, but exclude receivables and payables that arise from statutory rights and obligations. This is the case both under current requirements in PBE Standards and under PBE IFRS 9. Therefore, statutory receivables and payables are outside the scope of this publication.

PBE IFRS 9 *Financial Instruments*: at a glance

Why was the new standard issued?

Most PBEs hold financial instruments. Currently, PBEs in New Zealand account for their financial instruments as per the requirements of PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*. This standard is ultimately based on the for-profit standard, NZ IAS 39 *Financial Instruments: Recognition and Measurement*.

In 2014, the New Zealand Accounting Standards Board (NZASB) issued NZ IFRS 9 *Financial Instruments* as a replacement for NZ IAS 39, with a view to improve both the quality and the cost-benefit aspect of accounting for and reporting on financial instruments. The effective date of NZ IFRS 9 for for-profit entities is 1 January 2018, with early application permitted. The new standard would create significant differences between the requirements of NZ IFRS and PBE Standards if similar changes were not introduced for PBEs. Although the International Public Sector Accounting Standards Board (IPSASB) has an active project to update its standard on financial instruments, the NZASB did not want to wait until this project was completed before issuing its version of IFRS 9. At the time of writing this publication, the IPSASB's proposed updates are yet to be finalised and issued.

The NZASB therefore decided to issue PBE IFRS 9, which is based on IFRS 9. The new standard will eliminate most differences between NZ IFRS 9 and PBE IPSAS 29, making it easier for "mixed" groups that contain both PBEs and for-profit entities to prepare consolidated financial statements, and allowing PBEs and readers of their financial statements to enjoy the same benefits of higher quality financial reporting and greater cost efficiency that NZ IFRS 9 aims to bring to the for-profit sector.

Which PBEs will need to comply with the new standard?

PBE IFRS 9 will apply to all PBEs - that is, both public sector and not-for-profit PBEs - which fall into Tier 1 or Tier 2 of the XRB's accounting standards framework.

As PBE IFRS 9 deals with the recognition and measurement of financial instruments, rather than disclosure, all of the accounting requirements in PBE IFRS 9 will apply equally to both Tier 1 and Tier 2 PBEs. However, PBE IFRS 9 also includes consequential amendments to PBE IPSAS 30 *Financial Instruments: Disclosure*. PBEs in Tier 2 will have some disclosure concessions in relation to the new and amended disclosure requirements as a consequence of PBE IFRS 9.

PBEs in Tier 3 and Tier 4 will not need to comply with PBE IFRS 9. However, a Tier 3 PBE could choose to do so in certain circumstances, as set out in the Tier 3 standard PBE Simple Format Reporting - Accrual.

When does the new standard apply?

PBE IFRS 9 is effective for periods beginning on or after 1 January 2021. Early application is permitted, and will in fact be required for certain public sector PBEs in New Zealand, as explained below.

In August 2017, the New Zealand Treasury announced its decision to adopt PBE IFRS 9 early in the financial statements of the New Zealand Government. According to the Treasury's announcement, PBE IFRS 9 will be applied in the Government's consolidated financial statements in the 2018/2019 financial year (which coincides with the mandatory effective date of NZ IFRS 9 for for-profit entities). Therefore, all government departments, and those Crown entities and other public sector PBEs who form part of the New Zealand Government group reporting entity, will need to apply PBE IFRS 9 in the year ended 30 June 2019 if they are in Tier 1 or Tier 2 of the PBE accounting standards framework. Such PBEs will also need to apply PBE IFRS 9 in all interim periods, if the PBE prepares interim financial statements.

All other public sector PBEs (i.e. those who do not form part of the New Zealand Government group reporting entity) in Tier 1 or Tier 2, and all not-for-profit PBEs (including charities) in Tier 1 or Tier 2, will need to apply PBE IFRS 9 in periods beginning on or after 1 January 2021, unless they choose to adopt this standard earlier. For example, PBEs with for-profit subsidiaries (i.e. "mixed groups") may wish to consider early adoption, in order to avoid the need to adjust the accounting for financial instruments of the for-profit entity on consolidation. In addition, PBEs that use, or have considered using, hedge accounting, may want to consider early adoption due to the increased flexibility around hedge accounting provided in PBE IFRS 9.

What does the new standard change?

In brief, PBE IFRS 9 introduces the following key changes:

- ▶ **Classification of financial instruments:** PBE IFRS 9 introduces a new model for classifying financial assets, whereby financial assets are classified based on the nature of their underlying cash flows and the business model under which the assets are held and managed. Specifically:
 - ▶ Whether cash flows reflect solely payments of interest and principal, or not.
 - ▶ Whether the asset is held to collect cash flows or held for trading purposes, or a mix of both.

In order to achieve measurement at amortised cost for financial assets, the cash flows must be solely payments of principal and interest, and the business model must be to hold the instrument to collect the contractual cash flows. If these two tests are not met, the financial asset will be measured at fair value. Where and how an entity then recognises the movements in fair value will depend on the business model, type of instrument or the entity's accounting policy choices.

The classification of a PBE's financial assets, and consequently the subsequent accounting for these assets, may change under PBE IFRS 9. The classification of financial liabilities is unlikely to change under the new standard.

- ▶ **Hedge Accounting:** PBE IFRS 9 introduces significant changes to the existing hedge accounting model. These new requirements are less rules-based than those set out in PBE IPSAS 29. For example, the 80-125% qualitative threshold for hedge effectiveness has been removed. The new standard should also enable PBEs to apply hedge accounting to a wider range of economic hedging strategies. For example, non-financial risk components (e.g. copper prices or electricity prices within a contract), or groups of items (including derivatives), can be hedged items.

The new standard also introduces the concept of "costs of hedging", where the time value of an option and the forward points of a forward contract can be excluded from the hedge relationship and accounted for as costs of hedging.

However, there are significant disclosure requirements to help communicate these risk management activities to users of the PBE's accounts.

Under the new hedge accounting model in PBE IFRS 9, a PBE may be able to apply hedge accounting to instruments and strategies that it cannot treat as hedges under the current requirements. However, if the PBE applies hedge accounting, it is expected that its disclosure requirements will increase under PBE IFRS 9 (although some disclosure concessions are available for PBEs in Tier 2).

- ▶ **Impairment:** PBE IFRS 9 introduces a new, forward-looking impairment model based on expected credit loss ("ECL"), which is different to the current "incurred loss" model in PBE IPSAS 29. The new impairment model will impact financial assets recognised at amortised cost (e.g. trade receivables) and debt instruments recognised at fair value through other comprehensive revenue and expense, as well as lease receivables. So even for those PBEs that are not financial institutions and have simple financial assets, the standard will require consideration of the model an entity uses to assess impairment. It is expected that the new model will bring forward the recognition of impairments.

The new ECL model is unlikely to significantly affect short-term receivables, but may have a significant impact on longer-term financial assets such as long-term receivables, loans advanced by the PBE and debt securities that are not measured at fair value. Under the ECL impairment model, credit losses on such financial assets may need to be recognised as impairment earlier than under PBE IPSAS 29.

Please refer to Appendix on page 6 for a more detailed explanation of the new standard's requirements.

How is PBE IFRS 9 different to NZ IFRS 9?

Although PBE IFRS 9 is based on the for-profit standard NZ IFRS 9, there are certain differences between the two standards that are worth noting. For example, unlike NZ IFRS 9, PBE IFRS 9 specifically addresses the accounting for financial instruments that arise from non-exchange transactions, such as concessionary loans. Also, certain differences arise from the fact that NZ IFRS 9 incorporates the requirements of the new for-profit standard on revenue, which currently are not included in PBE Standards. Please refer to Appendix for further details.

Next steps

As explained above, government departments and those Crown entities and other public sector PBEs that form part of the New Zealand Government group reporting entity will need to apply PBE IFRS 9 in the year beginning 1 July 2018. For all other PBEs in Tier 1 or Tier 2, PBE IFRS 9 will become effective for accounting periods beginning on or after 1 January 2021, but early adoption is allowed.

Given that NZ IFRS 9 will become effective for for-profit entities from 1 January 2018, it would be beneficial for PBEs with for-profit subsidiaries to adopt PBE IFRS 9 at the same time. Whether or not you will be adopting PBE IFRS 9 before its effective date, we recommend that you start preparing for this standard early, by doing the following:

- ▶ Assess which category each of your financial assets will be classified into under PBE IFRS 9, taking into account their contractual cash flows and the business model under which you hold them.
- ▶ Based on the above assessment, ascertain the accounting requirements for your financial instruments under PBE IFRS 9, and whether these are different to the requirements that you currently apply.
- ▶ For your debt instruments, determine whether you can use the “simplified” approach to impairment, or whether you need to use the general approach and keep track of changes in credit risk.
- ▶ Assess your entity’s risk management activities, consider whether certain risks and the instruments used to manage them are eligible to be designated as a hedge relationships under PBE IFRS 9, and determine whether to designate them as such.
- ▶ Ascertain the differences between your current disclosure requirements for financial instruments and the requirements under PBE IFRS 9.
- ▶ Identify whether you need to collect any additional information to be able to comply with the accounting and disclosure requirements of PBE IFRS 9 (e.g. information about changes in credit risk).
- ▶ Consider the transitional provisions of PBE IFRS 9 and how they will be applied on initial adoption.

How EY can help

Issue and steps	How EY can help
Gaining a general understanding of PBE IFRS 9	<ul style="list-style-type: none"> ▶ Design and deliver training sessions for personnel on the accounting implications of PBE IFRS 9.
Performing a preliminary assessment of the impact of PBE IFRS 9 on the financial statements	<ul style="list-style-type: none"> ▶ Perform pre-implementation impact assessments, including: <ul style="list-style-type: none"> ▶ Assessing the expected impact of implementing PBE IFRS 9 on surplus or deficit, the statement of changes in net assets/equity and the statement of financial position. ▶ Assessing the expected impact on key financial ratios and performance measures. ▶ Identifying new or changed financial statement disclosure requirements.
Interpreting and implementing PBE IFRS 9	<ul style="list-style-type: none"> ▶ Assist with the interpretation of the new accounting standard. ▶ Assist management in developing an implementation plan. ▶ Advise on project management, including timeline, tasks and resource allocation.
Benchmarking accounting policy decisions and financial statement disclosures against peers and others in the sector	<ul style="list-style-type: none"> ▶ Provide observations of how others are approaching the implementation of PBE IFRS 9, problems they are identifying and solutions developed. ▶ Assist in the comparison of peers and similar entities’ accounting policy decisions, disclosures and expected impact on the financial statements.
Advising management during implementation	<ul style="list-style-type: none"> ▶ Prepare progress reports and advise on the impact of PBE IFRS 9. ▶ Review and provide input into accounting manuals that management will approve.
Checking that the financial statements are prepared in accordance with the new standard	<ul style="list-style-type: none"> ▶ Perform financial statement GAAP compliance reviews, which will include a review of the disclosures required as a consequence of applying PBE IFRS 9.
Communicating the effect of changes in accounting policy decisions or reporting requirements to the public	<ul style="list-style-type: none"> ▶ Advise on developing a communication plan. ▶ Advise on drafting communications.



Appendix

PBE IFRS 9: Analysis of key considerations

Classification of financial instruments

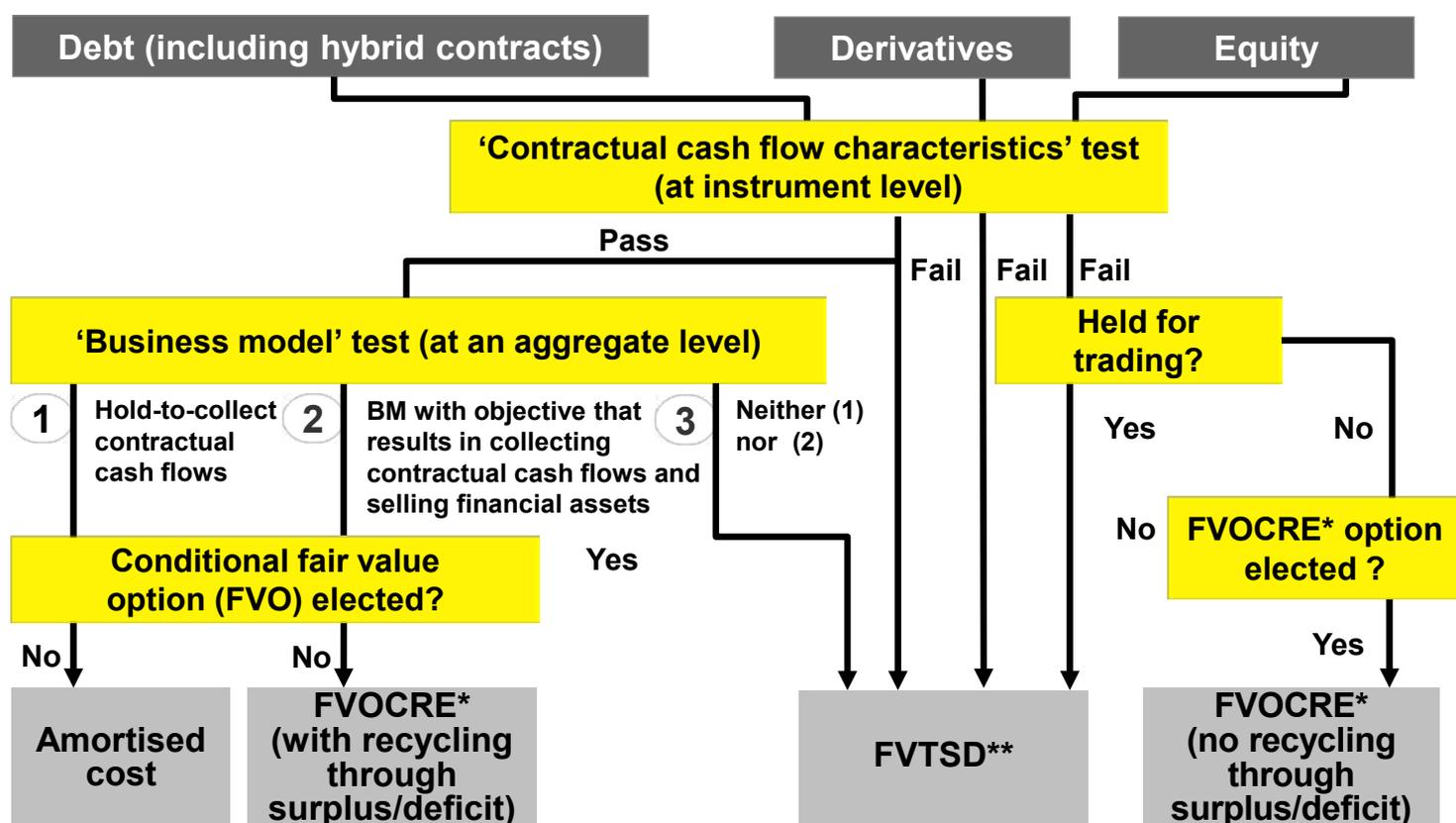
Key accounting requirements:

PBE IFRS 9 introduces a new principle-based model for classifying financial assets. Under this new model, the classification of a financial asset depends on the following two criteria:

- 1. The financial asset's contractual cash flow characteristics:** Whether the contractual cash flows to be received from the asset are solely payments of principal and interest ("SPPI"), or not. Principal is defined as the fair value of the asset on initial recognition, and "interest" is the consideration received for the time value of money, credit risk and other basic lending risks and costs associated with the outstanding principal, plus a profit margin. Thus, by definition, derivatives and equity instruments do not generate contractual cash flows that are "SPPI". Financial assets whose cash flows are SPPI will be accounted for differently to those that are not SPPI, as shown on the next page.
- 2. The entity's business model for managing the financial assets:** How the entity manages the financial assets in order to generate cash flows from them. This can be by (a) holding the asset and collecting contractual cash flows, or (b) by selling the asset, or (c) a combination of both. The accounting for (a), (b) and (c) will be different, as shown on the next page.

Financial Assets

The following diagram shows how these two classification criteria determine the category into which a financial asset falls into under PBE IFRS 9 (and therefore how that asset is accounted for):



*FVOCRE: Fair value through other comprehensive revenue and expense

**FVTSD: Fair value through surplus or deficit



Example: Classification of financial assets commonly held by PBEs under PBE IFRS 9

Please note that the FVOCRE category for debt instruments (which is different to the FVOCRE category for equity instruments) is not included in the table below, as this is not expected to be a common classification for debt instruments held by a PBE. For debt instruments (e.g. bonds) to be classified as FVOCRE, they must generate cash flows that are “SPPI” (see the previous page), and be held both to collect contractual cash flows and for sale. Unlike equity instruments, debt instruments classified as FVOCRE are subject to impairment testing, and fair value gains/losses are recycled through surplus or deficit.

Type of financial asset	Classification and subsequent measurement under PBE IFRS 9
Many simple debt instruments (e.g. short-term receivables from exchange and non-exchange transactions*, basic loans to other entities, basic concessionary loans**, basic deposits)	Amortised cost (NB: impairment requirements apply - see impairment section on the next page)
More complex debt instruments, where cash flows to be received are not solely payments of principal and interest	Fair value through surplus or deficit
Derivatives which are not designated in a hedging relationship (e.g. interest rate swaps, foreign exchange forward contracts)	Fair value through surplus or deficit
Equity instruments held for trading (e.g. shares or units in other entities that are held for trading)	Fair value through surplus or deficit
Equity instruments that are not held for trading and are designated as FVOCRE (e.g. shares or units in other entities, including unlisted entities, that are not held for trading)	Fair value through other comprehensive revenue and expense (NB: gains/losses are never recycled through surplus or deficit)

* Includes only receivables that arise from contractual rights. Receivables that arise from a statutory right to receive cash (e.g. government appropriations receivable, taxes receivable, rates receivable) would not meet the definition of a financial asset under PBE IFRS 9, and are therefore excluded from the scope of this standard.

** While it is expected that basic concessionary loans would normally continue to be measured at amortised cost under PBE IFRS 9, some concessionary loans may fail the classification criteria for measurement at amortised cost. This might happen, for example, if according to the loan agreement the borrower does not need to repay the principal in certain circumstances, which may cause the loan to fail the “SPPI” test (see the previous page). A concessionary loan that cannot be classified as amortised cost under PBE IFRS 9 would most likely need to be measured at fair value through surplus or deficit.

Financial Liabilities

The classification and accounting treatment of financial liabilities under PBE IFRS 9 will be similar to PBE IPSAS 29, except that for financial liabilities that are classified as FVTSD to prevent an accounting mismatch, changes in fair value that result from changes in the entity’s own credit risk are presented in OCRE, instead of in surplus or deficit.



Difference and impact on reporting:

The financial asset classification model under PBE IFRS 9 is somewhat different to PBE IPSAS 29, in terms of the categories themselves, the classification criteria for these categories, and the accounting treatment of the categories. This may cause changes in the classification and measurement of a PBE's financial instruments. For example:

- ▶ The classification and measurement of debt instruments that are currently classified as "available for sale" is likely to change under PBE IFRS 9. For example, at present, a PBE may classify bonds that it does not hold for trading as "available for sale", with fair value gains and losses recognised through OCRE. However, under PBE IFRS 9, the classification and measurement of the same bond may need to change to either amortised cost or fair value through surplus or deficit (see flowchart and table on the previous page), depending on the characteristics of the instrument's cash flows and the business model within which it is held.
- ▶ It is possible that some concessionary loans (e.g. ones with contingent repayment features) will fail the "SPPI" criterion and will therefore need to be measured at fair value through surplus or deficit.

- ▶ The "FVOCRE - equity" category in PBE IFRS 9 is not the same as the "available for sale" category in PBE IPSAS 29. Firstly, the "FVOCRE - equity" category does not allow for the recycling into surplus or deficit of the gains or losses previously recognised in OCRE, whereas PBE IPSAS 29 required this on disposal. Secondly, under PBE IPSAS 29, if there is a significant or prolonged decline in the value of an "available for sale" equity instrument, the impairment is recognised in profit or loss. This is not the case for "FVOCRE - equity" instruments under PBE IFRS 9: no changes in value are recorded in surplus or deficit (with the exception of dividends received, which will continue to be recognised in surplus or deficit).

PBEs will therefore need to assess the classification of their financial assets under PBE IFRS 9, and whether any change in accounting treatment is required.

Impairment

Key accounting requirements:

The impairment requirements under PBE IFRS 9 are based on a forward-looking expected credit loss model. This model applies to assets measured at amortised cost and to debt instruments measured at FVOCRE (see previous section). It also applies to lease receivables, loan commitments and financial guarantee contracts that are not at measured at FVTSD.

When applying the PBE IFRS 9 impairment model to an asset, an entity is required to identify possible future defaults by the counterparty, i.e. the possibility that, in the future, the counterparty will fail to make a payment in full and/or on time. The entity must recognise the expected credit loss ("ECL") arising from these possible future defaults as impairment losses through surplus or deficit, which decrease the carrying amount of the relevant asset.

Impairment is recognised either based on possible defaults expected over the lifetime of the asset, or over the next 12 months, depending on whether the "general approach" or the "simplified approach" to impairment is applied. This is shown in the diagram below.

Under both the simplified and general approach, the "lifetime ECL" requirement continues to apply once the asset becomes credit-impaired (i.e. once a default event has occurred). Also, for an asset that was already credit-impaired when it was originally acquired (i.e. when the entity had purchased the asset knowing that it will not be able to receive all the contractual cash flows that it is entitled to), the entity must recognise impairment losses based on "lifetime" ECL.

For receivables from exchange and non-exchange transactions and lease receivables:



Accounting policy choice: Apply one of the following options:

Option 1: *Simplified approach*

Impairment losses are recognised based on the "lifetime" ECL (i.e. future defaults expected to occur over the lifetime of the asset).

OR

Option 2: *General approach* (see right)

For most loans (including concessionary loans), debt securities (e.g. bonds) and financial guarantee contracts:



General approach:

If credit risk has not deteriorated significantly since the asset was initially recognised, impairment losses are recognised initially based on the ECL for the next 12 months.

However, if the credit risk associated with the asset deteriorates significantly, impairment losses are recognised based on the "lifetime" ECL (i.e. future defaults expected to occur over the lifetime of the asset).

Therefore, under the general approach, a PBE must keep track of the credit risk of the financial asset.

Practical considerations:

Tracking changes in credit risk under the general approach:

To assess whether credit risk has increased significantly (which is required under the general approach – see the diagram on the previous page), PBE IFRS 9 requires PBEs to use “reasonable and supportable information that is available without undue cost or effort”.

If repayments on a loan (or another asset that is tested for impairment under the general approach) are more than 30 days overdue, then there is a rebuttable presumption in PBE IFRS 9 that the credit risk on the loan/other asset has increased significantly. In addition, PBE IFRS 9 allows a PBE to determine whether credit risk increased significantly using actual past-due information, if more forward-looking information is not available without undue cost or effort.

PBE IFRS 9 also includes several indicators that may indicate a significant increase in credit risk, including:

- ▶ Actual/expected change in the asset’s external or internal credit rating.
- ▶ Actual/expected adverse change in the economic, regulatory or technological environment that would impact the borrower’s ability to meet its debt obligations (e.g. a significant increase in interest rates).

- ▶ Actual/expected adverse changes in the borrower’s operating results (e.g. declining revenue, working capital deficiencies, etc.).

If it is not possible to assess changes in credit risk for an individual asset, this may be assessed on a portfolio basis.

Measuring ECL:

Although PBE IFRS 9 requires impairment to be recognised based on future ECL, as a practical expedient the standard allows a PBE to use historic data to estimate ECL for assets such as receivables, as long as doing so is consistent with the principles of measuring ECL as per this standard (which include the reflection of future economic conditions, as well as past and current conditions). For example, a PBE can put its receivables into age “buckets” (current, 1-30 days past due, 31-60 days past due, etc.), and calculate the ECL for each bucket using the actual historic bad debts percentages. For example, if in the PBE’s experience 3% of receivables that are 1-30 days overdue are written off as bad debts, the PBE can estimate the ECL for receivables in this age bucket at 3%.

Difference and impact on reporting:

When assessing assets for impairment under PBE IFRS 9, entities will need to estimate and recognise credit losses arising from possible future default events, rather than recognising impairment only once the default occurs, as per PBE IPSAS 29. This is unlikely to significantly impact short-term receivables. However, for entities that hold longer-term debt instruments, this forward-looking aspect of the PBE IFRS 9 impairment model may cause impairment losses to be recognised earlier than under PBE IPSAS 29. In addition, under PBE IFRS 9 entities will have to keep track of changes in the credit risk relating to longer-term debt instruments, as this will affect the time period to be taken into account when determining ECL (unless one of the exceptions to the “general approach” applies – see above).

Hedge Accounting

Key accounting requirements and improvements to reporting:

The changes introduced by PBE IFRS 9 aim to simplify the hedge accounting model and to allow PBEs to better reflect in the financial statements the risk management activities that they carry out using financial instruments.

The table below summarises the key areas of change in hedge accounting under PBE IFRS 9:

Change under PBE IFRS 9	Explanation
Expanded ability to apply hedge accounting to risk components and net positions	<p>PBE IFRS 9 allows risk components of non-financial items to be designated as hedged item, provided the risk component is separately identifiable and reliably measurable.</p> <p>There is also an expanded ability to apply hedge accounting to net positions and to layers of hedged items in fair value hedges.</p>
Due to the removal of the 80-125% hedge effectiveness threshold, hedge effectiveness testing will be qualitative only for many hedges	<p>PBE IFRS 9 replaces the “bright-line” requirement to maintain hedge effectiveness within an 80-125% range with an objectives-based test. In addition to the requirement for a document risk management strategy, the effectiveness criteria under PBE IFRS 9 are:</p> <ul style="list-style-type: none"> ▶ There must be an “economic relationship” between the hedged item and the hedging instrument. ▶ The effects of credit risk must not dominate the fair value movements that result from the economic relationship. ▶ Normally, the “hedge ratio” (see next page) must be the same as the ratio that the entity actually uses for economic hedging/risk management purposes (but see next page regarding “anti-abuse” provisions). <p>Thus, as long as the hedge ratio is the same as the ratio used for risk management purposes (which is expected to be the case for most hedges, except some of the more complex ones), hedge effectiveness testing can be qualitative only.</p>
Retrospective effectiveness testing is not required	Under PBE IFRS 9, hedge effectiveness testing is prospective only.
Ability to exclude time value of options, forward points of forward contracts and FX basis spread from the hedge designation	When designating a financial instrument as a hedging instrument, the entity may exclude from this designation the time value of an option, the forward element of a forward contract, and any foreign currency basis spread. These elements may be treated as “costs of hedging” and recognise as an expense in surplus or deficit, similarly to transaction costs. This should decrease volatility in surplus or deficit.
Hedge accounting is discontinued only if the risk management objective changes or the other qualifying criteria are no longer met	<p>Hedge accounting must be discontinued if any of the following occur:</p> <ul style="list-style-type: none"> ▶ There is a change in the entity’s risk management objective in relation to the hedge, or; ▶ There is no longer an economic relationship between the hedged item and hedging instrument, or; ▶ The effect of credit risk dominates the value changes that result from the economic relationship, or; ▶ The hedge ratio is not the same as the ratio used for risk management purposes, and this cannot be rectified by re-balancing. <p>Hedge accounting cannot be discontinued for any other reason (e.g. ineffectiveness), and PBEs are not permitted to voluntarily de-designate a hedge relationship.</p>



Please note that under PBE IFRS 9, hedge ineffectiveness must still be recognised. That is, in general, when there is no “1:1” relationship between the movements in the hedged item and hedging instrument, the difference between the movements may need to be recognised as “hedge ineffectiveness” in surplus or deficit. Also, if hedge ineffectiveness is expected to continue in the future, the PBE may “re-balance” the hedge by increasing/ decreasing the volume of hedged item and/or hedging instrument. Neither the existence of ineffectiveness nor the re-balancing of the hedge will cause hedge effectiveness to be discontinued.

The “hedge ratio” referred to in the table on the previous page is the ratio between the amounts of hedged item and hedging instrument for hedge

accounting purposes. While there is no specific range (such as 80%-125%) that this ratio must fall into, it must normally be the same as the ratio used for economic hedging/risk management purposes. For example, if an entity chooses to only designate a portion of an interest rate swap and a portion of a floating-rate loan in a hedge relationship for accounting purposes, the ratio between the two portions must be the same as the ratio between the full amount of the notional principal in the swap and full amount of the loan, as this reflects the entity’s actual risk management activities. However, PBE IFRS 9 contains an “anti-abuse” provision to prevent entities from deliberately over- or under-hedging. Thus, in some cases the hedge ratio will have to differ from the ratio used for risk management purposes.

Impact on accounting and financial reporting:

Overall, the new hedge accounting requirements under PBE IFRS 9 should result in more risk management strategies qualifying for hedge accounting, and provide a better link between an entity’s risk management strategy and the impact of hedging on the financial statements. However, additional disclosure requirements will apply (please see below).

Disclosure requirements (PBE IPSAS 30)

Although PBE IFRS 9 itself deals with accounting requirements only, the standard includes amendments to PBE IPSAS 30 *Financial Instruments: Disclosure*, as a consequence of the changes introduced by PBE IFRS 9. The changes in disclosure requirements include the following:

- ▶ **Classification of financial instruments:** Disclosure will be required as to which equity investments have been classified as FVOCRE, the reason for choosing this classification, and the fair value of each material investment classified in this category.
- ▶ **Impairment:** The impairment disclosures are expanded significantly as a consequence of PBE IFRS 9, so that users of financial statements can better understand the effect of credit risk and expected credit losses on the amount, timing and uncertainty of future cash flows relating to financial assets.

- ▶ **Hedging:** As a consequence of PBE IFRS 9, PBE IPSAS 30 will require a much more detailed qualitative description of the entity’s risk management strategy with respect to hedges, including information about how hedged risks arise, how the hedge ratio is determined, what are the expected sources of ineffectiveness, and – if only a component of the risk is hedged – how the component is determined.

Some disclosure concessions are available to PBEs in Tier 2 that apply PBE Standards Reduced Disclosure Regime (RDR).

Entities should assess how these changes in disclosure, as well as the disclosure concessions for Tier 2 entities, will affect their financial statements.

Transitional provisions

When applying PBE IFRS 9 for the first time, PBEs generally will need to apply the standard retrospectively and make adjustments to previous accounting periods, unless it is not practicable to do so. However, PBE IFRS 9 contains a number of exceptions to retrospective application. For example, PBE IFRS 9:

- ▶ Requires prospective application of the hedge accounting requirements except for those for the cost of hedging, which need to be applied retrospectively. Further, an entity is able to continue to use PBE IPSAS 29 for hedging instead of moving to the requirements under PBE IFRS 9.

- ▶ Grants an exception to restating comparatives for classification and measurement and impairment, but not for hedge accounting. This means that comparative periods need to be restated for the effect of retrospectively applying the costs of hedging requirements if those are applied, even if an entity chooses not to restate for the effect of applying the classification and measurement and impairment requirements of PBE IFRS 9.

PBEs should refer to the transitional provisions in PBE IFRS 9.

How is PBE IFRS 9 different to NZ IFRS 9?

Although PBE IFRS 9 is based on the for-profit standard NZ IFRS 9, there are certain differences between the two standards that are worth noting. In particular, PBEs that have for-profit subsidiaries (i.e. “mixed group”) and must consolidate these subsidiaries into their group financial statements should bear these differences in mind, as they could potentially give rise to consolidation adjustments. The following are the key differences between PBE IFRS 9 and NZ IFRS 9:

- ▶ Unlike NZ IFRS 9, PBE IFRS 9 specifically addresses financial instruments that arise from non-exchange transactions, including concessionary loans. Similarly to the current requirements of PBE IPSAS 29, PBE IFRS 9 requires financial assets arising from non-exchange transactions to be initially measured at fair value and provides specific guidance on the recognition and measurement of concessionary loans granted or received by a PBE (including a reference to PBE IPSAS 23 *Revenue from Non-Exchange Transactions* for an illustrative example of a concessionary loan received by a PBE).
- ▶ The requirements of the new for-profit standard NZ IFRS 15 *Revenue from Contracts with Customers* was not incorporated into PBE IFRS 9, as there is currently no equivalent to this for-profit standard in PBE Standards. Conversely, NZ IFRS 9 takes into account the requirements of NZ IFRS 15. This results in certain differences between the requirements of PBE IFRS 9 and NZ IFRS 9. For example:
 - ▶ Initial recognition at receivables: PBE IFRS 9 requires all financial instruments to be recognised initially at fair value. However, NZ IFRS 9 makes an exception for trade receivables, which must be measured at their “transaction price” as defined in NZ IFRS 15 (unless a significant financing component exists). A receivable’s transaction price may not be the same as its fair value on initial recognition; therefore, a PBE that has for-profit subsidiaries will need to consider whether the difference is material when preparing consolidated financial statements.

- ▶ Impairment of receivables: Under PBE IFRS 9, the ECL on receivables may be calculated using either the general approach or the simplified approach (as discussed earlier). However, under NZ IFRS 9, for trade receivables that do not have a significant financing component, ECL must be measured using the simplified approach (i.e. there is no policy choice). Thus, if a PBE that has for-profit subsidiaries chooses to measure ECL on receivables using the general approach, the PBE may need to make adjustments when consolidating the trade receivables of its for-profit subsidiaries. However, such potential adjustments can be avoided if the PBE chooses the simplified approach for measuring ECL on receivables.
- ▶ The definition of “fair value” and the requirements around fair value measurement in PBE IFRS 9 have been carried forward from PBE IPSAS 29, and are not identical to the fair value definition and requirements in NZ IFRS 9 (which makes reference to NZ IFRS 13 *Fair Value Measurement*).
- ▶ For PBEs that issue financial guarantees: A PBE that chooses to apply PBE IFRS 4 *Insurance Contracts* (rather than PBE IFRS 9) to a financial guarantee contract that it issued needs not make an explicit assertion that this contract is an insurance contract, whereas NZ IFRS 9 requires such an assertion. In addition, unlike NZ IFRS 9, PBE IFRS 9 includes guidance around the measurement of financial guarantees issued in non-exchange transactions (which has been carried through from PBE IPSAS 29).

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APAC No. NZ00000913
NZ1730981
ED None

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