

AASB 9 - Simplifying hedge accounting

Insights on Practical Application for Corporates

The new financial instruments standard, AASB 9, reduces the constraints associated with hedge accounting, allows more types of hedging relationships and helps reduce income statement volatility. Not surprisingly, a number of corporates are early adopting AASB 9 to take advantage of these benefits. There are, however, a number of other new requirements that early adopters need to consider. This publication looks at the benefits of early adopting AASB 9 for hedging and provides some insights into these other requirements.

The benefits of early adopting hedge accounting under AASB 9

Although the core principals and purpose of hedge accounting have not changed, AASB 9 simplifies hedge accounting and aligns it with the overall risk management strategies of companies. The chart below summarises the aspects of hedge accounting that have been simplified under the new standard and the key benefits for corporates:

Simplification	Benefit of simplification
<ul style="list-style-type: none"> ➔ Less restrictive criteria to qualify for hedge accounting. The requirement to demonstrate an economic relationship between the hedged item and hedged instrument replaces the quantitative 80-125% hedge effectiveness threshold 	<ul style="list-style-type: none"> ➔ This will permit more hedging relationships to be designated and should see more hedge relationships continue that may have failed under the existing hedge effectiveness threshold
<ul style="list-style-type: none"> ➔ Retrospective effectiveness tests are no longer required 	<ul style="list-style-type: none"> ➔ Although corporates still need to measure ineffectiveness, the onerous burden of formally demonstrating highly effective hedges is removed
<ul style="list-style-type: none"> ➔ The hedge relationship can be rebalanced when circumstances change but the risk management objective remains the same 	<ul style="list-style-type: none"> ➔ Should see more hedge relationships continue that may have failed under the existing 80-125% effectiveness threshold
<ul style="list-style-type: none"> ➔ The exposures that can be subject to hedge accounting have been broadened. These include: <ul style="list-style-type: none"> • aggregated exposures • components of non financial items, and • groups of items such as net positions and layers of transactions 	<ul style="list-style-type: none"> ➔ Should reduce profit and loss volatility in a number of areas, including: <ul style="list-style-type: none"> • Aggregated exposures – for example, a debt and a swap can now be included as a hedged item. This could benefit companies that raise fixed rate overseas funding and swap the foreign currency cash flows back to fixed AUD using a combination of cross currency and AUD interest rate swaps • Components of non financial items – for example, the aluminium in a can could be separately hedged using aluminium futures as opposed to the cost of the entire can itself. • Net positions – for example, purchases and sales in a single currency could be hedged based on their net exposure. Hedging such a position is more difficult under the existing guidance.
<ul style="list-style-type: none"> ➔ When hedging with options or cross currency swaps, fair value changes due to time value in options and currency basis in cross currency swaps can be deferred in equity. 	<ul style="list-style-type: none"> ➔ May reduce income statement volatility by deferring time value of options and currency basis in cross currency swaps in equity and amortising them to P&L on a systematic and rational basis

Corporates adopting AASB 9 for hedge accounting must also apply its impairment of financial assets requirements and classification and measurement requirements. We consider these below.

Impairment of financial assets

The new requirements in AASB 9 introduces a forward looking expected loss model that replaces the existing incurred loss model. A credit loss provision will be required on initial recognition of financial assets subject to these requirements. This means that a credit event is no longer required before a credit loss provision is recognised. This provision will usually be based on expected credit losses arising from default events over a 12 month period following initial recognition. However, over time, when there has been a significant increase in the credit risk of the financial asset, the provision needs to be updated using expected credit loss data arising from default events over its lifetime, and not just for 12 months. For corporates, however, there are a number of operational simplifications available when applying these impairment requirements. We consider these below.

Simplification approach

- There are options on how to measure the expected credit loss provision for trade receivables and certain other financial assets, including those with low credit risk. The aim of this simplification is to reduce the burden of assessing when a significant increase in credit risk has occurred for these assets
- For trade receivables, the guidance allows the use of a provision matrix (e.g. based on ageing) to measure the provision. The use of such a tool provides some relief from tracking deterioration in credit risk on receivables individually
- In practice, for corporates with a rolling portfolio of receivables, the provision may not move significantly after its initial recognition.

Challenges

- Determining the provision for financial assets that are outside the scope of the operational simplifications (eg. investments in debt securities with high credit risk)
- For these assets, corporates must consider forward looking information, including macroeconomic factors, to determine provisions. Collecting and manipulating such information may require considerable cost and effort
- Corporates will also need to periodically assess if there has been a significant increase in credit risk for these assets
- Considering the amount of provision and determining what is significant will require judgement and consideration of materiality

Classification and measurement of financial assets and financial liabilities

AASB 9 has a more simplified approach for classifying and measuring financial assets. All equity investments are measured at fair value through profit and loss (FVTPL) unless the exception detailed below is taken up. Debt investments are subject to two assessments based on the asset's contractual cash flow characteristics and the way it is managed by the entity. Depending on the outcome of these assessments, debt investments can be measured at either amortised cost, fair value through other comprehensive income (FVOCI) or FVTPL. There has been no substantial changes to the measurement of financial liabilities. The diagram below outlines some of the benefits and challenges to corporates when applying the classification and measurement requirements.

Benefits

- Investments in equities not held for trading can be measured at FVOCI, minimising P&L volatility.
- Embedded derivatives in financial assets are no longer required to be separated, removing an onerous burden under the existing guidance
- Investments in listed debt investments may be accounted for at amortised cost instead of fair value, which may be easier to measure
- Movements in fair value due to an entity's own credit risk for financial liabilities elected to be measured at FVTPL is taken through equity, minimising P&L volatility.

Challenges

- Investments in unquoted equities can now only be measured at cost in very limited circumstances which is expected to be rare.
- Changing the measurement category for a debt investment is subject to a high hurdle
- Investments currently accounted for as Available-for-sale may no longer meet the criteria for FVOCI classification and result in FVTPL classification
- Determining the contractual cash flow characteristics and the way the entity manages financial assets may require significant judgement

By and large, the new guidance is proving attractive for hedging with a few early adopters already capitalising on the benefits. We can assist you with implementation of AASB 9 through impact assessments, detailed training, implementation and assurance over necessary controls and processes, and formal accounting advice.

Let's talk...

For more information, please speak to your usual PwC contact or one of our team listed below.

Accounting advisory

Paul Brunner

Partner, Sydney

+61 2 8266 4664

paul.brunner@au.pwc.com

Regina Fikkers

Partner, Sydney

+61 2 8266 8350

regina.fikkers@au.pwc.com

Soter Tiong

Director, Melbourne

+61 3 8603 1527

soter.tiong@au.pwc.com

Yannick Maurice

Director, Brisbane

+61 7 3257 5058

yannick.x.maurice@au.pwc.com

Treasury, Liquidity – Capital Risk Management

Ashley Rockman

Partner, Sydney

+61 2 8266 1882

ashley.b.rockman@au.pwc.com

Actuarial

Craig Prior

Director, Sydney

+61 2 8266 0841

craig.prior@au.pwc.com

Donald Macdonald

Director, Sydney

+61 2 8266 0932

donald.macdonald@au.pwc.com

Nina Larkin

Director, Melbourne

+61 3 8603 0329

nina.larkin@au.pwc.com

Tax

Gavin Marjoram

Partner, Sydney

+61 2 8266 0576

gavin.marjoram@au.pwc.com

Matt Osmond

Partner, Melbourne

+61 3 8603 5883

matt.osmond@au.pwc.com

www.pwc.com.au

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