NZ IFRS 9: FINANCIAL INSTRUMENTS (1 OF 6)

Version 1: 2024

Effective Periods Beginning 1 January 2018

BACKGROUND
(IFRS 9 replaced IAS 39 Financial Instruments: Recognition and Measurement except for entities that continue to apply relevant hedge accounting guidance in IAS 39)

NZ IFRS 9 introduces a single classification and measurement model for financial assets, dependent on both:

- The entity's business model objective for managing financial assets
- The contractual cash flow characteristics of financial assets.

NZ IFRS 9 removes the requirement to separate embedded derivatives from financial asset host contracts (it instead requires a hybrid contract to be classified in its entirety at either amortised cost or fair value.)

Separation of embedded derivatives has been retained for financial liabilities (subject to criteria being met).

INITIAL RECOGNITION AND MEASUREMENT (FINANCIAL ASSETS AND FINANCIAL LIABILITIES)

Initial Recognition

When the entity becomes party to the contractual provisions of the instrument.

Initial Measurement

At fair value, plus for those financial assets and liabilities not classified at fair value through profit or loss, directly attributable transaction costs.

- Fair value – the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- Directly attributable transaction costs - incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.

FINANCIAL ASSETS - SUBSEQUENT CLASSIFICATION AND MEASUREMENT

Financial Assets are classified as either: (1) Amortised Cost, (2) Fair value through profit or loss , or (3) Fair value through other comprehensive income .

(1) Amortised cost

Category classification criteria

Both of the below conditions must be met:

- Business model objective: financial assets held in order to collect contractual cash flows
- Contractual cash flow characteristics: solely payments of principal and interest on the principal amount outstanding.

Subsequent measurement

- Amortised cost using the effective interest method.

(i) Business model assessment

Based on the overall business, not instrument-by-instrument

Centres on whether financial assets are held to collect contractual cash flows:

- How the entity is run
- The objective of the business model as determined by key management personnel (KMP) (per NZ IAS 24 *Related Party Disclosures*).

Financial assets do not have to be held to contractual maturity in order to be deemed to be held to collect contractual cash flows, but the overall approach must be consistent with 'hold to collect'.

(ii) Contractual cash flow assessment

Based on an instrument-by-instrument basis

Financial assets with cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding.

Interest is consideration for only the time-value of money and credit risk.

FOREX financial assets: assessment is made in the denomination currency (i.e. FX movements are not taken into account).

NZ IFRS 9 contains various illustrative examples in the application of both the (i) Business Model Assessment and (ii) Contractual Cash Flow Characteristics.

(2) Fair value through profit or loss

Category classification criteria

- Financial assets that do not meet the amortised cost criteria (also includes assets held for trading).
- Financial assets designated at initial recognition. The option to designate is available if doing so eliminates, or significantly reduces, a measurement or recognition inconsistency (i.e. 'accounting mismatch').

Note: the option to designate is irrevocable.

Subsequent measurement

- Fair value, with all gains and losses recognised in profit or loss.

(3) Fair value through other comprehensive income

Equity Instruments

Note: Designation at initial recognition is optional and irrevocable.

Category classification criteria

- Available only for investments in equity instruments (within the scope of NZ IFRS 9) that are not held for trading.

Subsequent measurement

- Fair value, with all gains and losses recognised in other comprehensive income
- Changes in fair value are not subsequently recycled to profit and loss
- Dividends are recognised in profit or loss.

Debt Instruments

Category classification criteria

- Meets the SPPI contractual cash flow characteristics test (see box (1)(ii) above)
- Entity holds the instrument to collect contractual cash flows and to sell the financial assets

Subsequent measurement

- Fair value, with all gains and losses (other than those relating to impairment, which are included in profit or loss) being recognised in other comprehensive income
- Changes in fair value recorded in other comprehensive income are recycled to profit or loss on derecognition or reclassification.

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Effective Periods Beginning 1 January 2018

IMPAIRMENT OF FINANCIL ASSETS

Scope

The impairment requirements are applied to:

- Financial assets measured at amortised cost (incl. trade receivables)
- Financial assets measured at fair value through OCI
- Loan commitments at below market interest rate
- Financial guarantees contracts which are not insurance contracts under the scope of NZ IFRS 17 *Insurance Contracts*
- Lease receivables.

The impairment model follows a three-stage approach based on changes in expected credit losses of a financial instrument that determine

- The recognition of impairment, and
- The recognition of interest revenue.

Initial recognition

At initial recognition of the financial asset an entity recognises a loss allowance equal to 12 months expected credit losses which consist of expected credit losses from default events possible within 12 months from the entity's reporting date. An exception is purchased or originated credit impaired financial assets.

Subsequent measurement

Stage	1	2	3
Impairment	12 month expected credit loss	Lifetime expected credit loss	
Interest	Effective interest on the gross carrying amount (before deducting expected losses)		Effective interest on the net (carrying) amount

THREE-STAGE APPROACH

STAGE 1

12 month expected credit losses (gross interest)

- Applicable when no significant increase in credit risk
- Entities continue to recognise 12 month expected losses that are updated at each reporting date
- Presentation of interest on gross basis

STAGE 2

Lifetime expected credit losses (gross interest)

- Applicable in case of significant increase in credit risk
- Recognition of lifetime expected losses
- Presentation of interest on gross basis

STAGE 3

Lifetime expected credit losses (net interest)

- Applicable in case of credit impairment
- Recognition of lifetime expected losses
- Presentation of interest on a net basis

PRACTICAL EXPEDIENTS

30 days past due rebuttable Presumption

- Rebuttable presumption that credit risk has increased significantly when contractual payments are more than 30 days past due
- When payments are 30 days past due, a financial asset is considered to be in stage 2 and lifetime expected credit losses would be recognised
- An entity can rebut this presumption when it has reasonable and supportable Information available that demonstrates that even if payments are 30 days or more past due, it does not represent a significant increase in the credit risk of a financial instrument.

Low credit risk instruments

- Instruments that have a low risk of default and the counterparties have a strong capacity to repay (e.g. financial instruments that are of investment grade)
- Instruments would remain in stage 1, and only 12 month expected credit losses would be provided.

SIMPLIFIED APPROACH

Short term trade receivables

- Recognition of only 'lifetime expected credit losses' (i.e. stage 2)
- Expected credit losses on trade receivables can be calculated using provision matrix (e.g. geographical region, product type, customer rating, collateral or trade credit insurance, or type of customer)
- Entities will need to adjust the historical provision rates to reflect relevant information about current conditions and reasonable and supportable forecasts about future expectations.

Long term trade receivables and lease receivables

Entities have a choice to either apply:

- The three-stage expected credit loss model; or
- The 'simplified approach' where only lifetime expected credit losses are recognised.

LOAN COMMITMENTS AND FINANCIAL GUARANTEES

- The three-stage expected credit loss model also applies to these off balance sheet financial commitments
- An entity considers the expected portion of a loan commitment that will be drawn down within the next 12 months when estimating 12 month expected credit losses (stage 1), and the expected portion of the loan commitment that will be drawn down over the remaining life the loan commitment (stage 2)
- For loan commitments that are managed on a collective basis an entity estimates expected credit losses over the period until the entity has the practical ability to withdraw the loan commitment.

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FINANCIAL LIABILTIES - SUBSEQUENT CLASSIFICATION AND MEASUREMENT

Financial Liabilities are classified as either: (1) Amortised Cost, (2) Fair value through profit or loss.

In addition, specific guidance exists for:

(i) Financial guarantee contracts, and (ii) Commitments to provide a loan at a below market interest rate

(iii) Financial Liabilities that arise when the transfer of a financial asset either does not qualify for derecognition or where there is continuing involvement.

(1) Amortised cost

Category classification criteria

All financial liabilities, except those that meet the criteria of (2), (i), and (ii).

Subsequent measurement

- Amortised cost using the effective interest method.

(2) Fair value through profit or loss

Category classification criteria

- Financial liabilities held for trading
- Derivative financial liabilities
- Financial liabilities designated at initial recognition The option to designate is available:
  - If doing so eliminates, or significantly reduces, a measurement or recognition inconsistency (i.e. 'accounting mismatch'), or
  - If a group of financial liabilities (or financial assets and financial liabilities) is managed, and evaluated, on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally to KMP.

Subsequent measurement

- Fair value with all gains and losses being recognised in profit or loss.

(i) Financial guarantee contracts (ii) Commitments to provide a loan at a below market interest rate

Subsequent measurement (the higher of either)

- The amount determined in accordance with NZ IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- The amount initially recognised, less (when appropriate) cumulative amortisation recognised in accordance with NZ IFRS 15 *Revenue from Contracts with Customers*.

(iii) Financial liabilities resulting from the transfer of a financial asset

(That does not qualify for derecognition)
(Where there is continuing involvement)

Financial liability for the consideration received is recognised.

Subsequent measurement

The net carrying amount of the transferred asset and associated liability is measured as either:

- Amortised cost of the rights and obligations retained (if the transferred asset is measured at amortised cost)
- The fair value of the rights and obligations retained by the entity when measured on a stand-alone basis (if the transferred asset is measured at fair value).

EMBEDDED DERIVATIVES

Definition and description

Embedded derivatives are components of a hybrid contract (i.e. a contract that also includes a non-derivative host), that causes some (or all) of the contractual cash flows to be modified according to a specified variable (e.g. interest rate, commodity price, foreign exchange rate, index, etc.)

Exclusions and exemptions (i.e. not embedded derivatives)

- Non-financial variables that are specific to a party to the contract.
- A derivative, attached to a financial instrument that is contractually transferable independently of that instrument, or, has a different counterparty from that instrument.
  - Instead, this is a separate financial instrument.

Embedded derivatives are accounted for differently depending on whether they are within a host contract that is a financial asset or a financial liability.

Embedded derivatives within a financial asset host contract

The embedded derivative is not separated from the host contract

Instead, the whole contract in its entirety is accounted for as a single instrument in accordance with the requirements of NZ IFRS 9.

Embedded derivatives within a host contract that is a financial liability

Subject to meeting the adjacent criteria, the embedded derivative is:

- Separated from the host contract
- Accounted for as a derivative in accordance with NZ IFRS 9 (i.e. at fair value through profit or loss).

Criteria: to separate an embedded derivative

- Economic characteristics of the embedded derivative and host are not closely related
- An identical instrument (with the same terms) would meet the definition of a derivative, and
- The entire (hybrid) contract is not measured at fair value through profit or loss.

Host contract (once embedded derivative is separated)

The (non-financial asset) host contract is accounted for in accordance with the appropriate NZ IFRS.

TRANSITION

Retrospective application in accordance with NZ IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, subject to certain exemptions and reliefs (refer section 7.2 of NZ IFRS 9).

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NZ IFRS 9: FINANCIAL INSTRUMENTS (4 OF 6)

DERECOGNITION

FINANCIAL ASSETS

Consolidate all subsidiaries in accordance with NZ IFRS 10 *Consolidated Financial Statements*

↓

Determine whether the derecognition principles below are applied to all or part of the asset.

↓

Have the rights to the cash flows from the asset expired?
- YES → Derecognise the asset
- NO ↓

Has the entity transferred its rights to receive the cash flows from the asset?
- YES → Has the entity transferred substantially all risks and rewards?
- NO ↓

Has the entity assumed an obligation to pay the cash flows from the asset that meets the conditions in IFRS 9 paragraph 3.2.5?
- NO → Continue to recognise the asset
- YES ↓

Has the entity transferred substantially all risks and rewards?
- YES → Derecognise the asset
- NO ↓

Has the entity retained substantially all risks and rewards?
- YES → Continue to recognise the asset
- NO ↓

Has the entity retained control of the asset?
- NO → Derecognise the asset
- YES ↓

Continue to recognise asset to the extent of the entity's continuing involvement.

- If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it recognises either a servicing asset or liability for that servicing contract
- If, as a result of a transfer, a financial asset is derecognised, but the entity obtains a new financial asset or assumes a new financial liability or servicing liability, the entity recognises the new financial asset, financial liability or servicing liability at fair value
- On derecognition of a financial asset, the difference between the carrying amount and the sum of (i) the consideration received and (ii) any cumulative gain or loss that was recognised directly in equity is recognised in profit or loss.

NZ IFRS 9 paragraph 3.2.5 – where an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay those cash flows to one or more entities, three conditions need to be met before an entity can consider the additional derecognition criteria:

- The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset
- The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients
- The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. The entity is not entitled to reinvest the cash flows except for the short period between collection and remittance to the eventual recipients. Any interest earned thereon is remitted to the eventual recipients.

FINANCIAL LIABILITIES

- A financial liability is derecognised only when extinguished – i.e., when the obligation specified in the contract is discharged, cancelled or it expires
- An exchange between an existing borrower and lender of debt instruments with substantially different terms or substantial modification of the terms of an existing financial liability of part thereof is accounted for as an extinguishment
- The difference between the carrying amount of a financial liability extinguished or transferred to a 3rd party and the consideration paid is recognised in profit or loss.

TIER 2 NZ IFRS RDR REPORTERS

NZ IFRS RDR Reporters must comply with all the provisions in NZ IFRS 9.

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Effective Periods Beginning
1 January 2018

CRITERIA TO APPLY HEDGE ACCOUNTING (ALL CRITERIA MUST BE MET)

(i) Hedging Relationship

Must consist of:

- Eligible hedging instruments
- Eligible hedged items.

(ii) Designation and Documentation

Must be formalised at the inception of the hedging relationship:

- The hedging relationship
- Risk management strategy and objective for undertaking the hedge
- The hedged item and hedging instrument
- How hedge effectiveness will be assessed.

(iii) All three hedge effectiveness requirements met

a) An economic relationship exists between the hedged item and hedging instrument

b) Credit risk does not dominate changes in value

c) The hedge ratio is the is the same for both the:

- Hedging relationship
- Quantity of the hedged item actually hedged, and the quantity of the hedging instrument used to hedge it.

ELIGIBLE HEDGING INSTRUMENTS

Only those with from contracts with EXTERNAL parties of the entity (or group), that are:

Derivatives measured at fair value through profit or loss (FVTPL).

Note: this excludes written options unless they are designated as an offset to a purchased option.

Non-derivatives measured at fair value through profit or loss (FVTPL).

Note: this excludes FVTPL financial liabilities where fair value changes resulting from changes in own credit risk are recognised in other comprehensive income (OCI).
Note: In hedge of foreign currency risk, other financial instruments maybe designated.

Designation: An entity must designate a hedging instrument in full, except for:

- A proportion (e.g. 50%) of the nominal amount of an entire hedging instrument (but not part of the fair value change resulting from a portion of the time period that the hedging instrument is outstanding)
- Option contracts: separating the intrinsic value and time value, and designating only the change in intrinsic value
- Forward contract: separating the forward element and spot element, and designating only the change in the spot element.

ELIGIBLE HEDGED ITEMS

Eligible hedged items are reliably measurable: assets; liabilities; unrecognised firm commitment; highly probable forecast transactions; net investment in a foreign operation. May be a single item, or a group of items (subject to additional criteria - below).

HEDGES OF A GROUP OF ITEMS (ALL CRITERIA MUST BE MET)

i. All items and (and components) are eligible hedged items

ii. The items are managed as a group for risk management purposes.

iii. For group cash flow hedges: where cash flow variability is not expected to be approximately proportional to the overall group cash flows variability, both:

- Foreign currency is being hedged
- The reporting period, nature, and volume, in which the forecast transactions are expected to affect profit or loss is specified.

Designation: An entity can designate a hedged item (i) in full (ii) in part (component). If in part, only the following types of parts (components) of hedged items can be hedged:

- One or more selected contractual cash flows
- Parts (components) of a nominal amount
- Separately identifiable and reliably measureable changes (cash flow or fair value) that, based on the context of the market structure they relate to, are attributable to a specific risk(s).

HEDGING OF GROUP ENTITY TRANSACTIONS

Hedging of group entity transactions is not applied in the consolidated financial statements of group entities, except for:

- Foreign currency risk on intra-group monetary items that are not fully eliminated on consolidation.
- Investment entities where transactions between the parent and subsidiaries measured at fair value are not subject to elimination adjustments.

Hedging of group entity transactions is able to be applied in separate/individual financial statements of group entities.

REBALANCING

If the hedge ratio hedge effectiveness test ceases to be met, but the risk management objective is unchanged, an entity adjusts ('rebalances'), the hedge ratio so the criteria is once again met.

DISCONTINUATION

Hedge accounting is discontinued only if the qualifying criteria are no longer met (after applying 'rebalancing'). This including hedging instrument sale / termination / expiration, but excluding:

- Replacement/rollovers documented in the risk management objective
- Novations of hedging instruments (subject to specific criteria).

ELIGIBLE HEDGED ITEMS

(i) Cash flow hedge

Hedge of exposure to cash flow variability in cash attributable to a particular risk associated with an asset, liability, or highly probable forecast transaction (or part thereof i.e. component).

Recognition

- Hedge effectiveness is recognised in OCI.
- Hedge ineffectiveness is recognised in profit or loss.
- The lower of the cumulative gain or loss on the hedging instrument or fair value in the hedged item is recognised separately within equity (cash flow hedge reserve (CFHR)).
- For forecast transactions resulting in a non-financial asset/liability, the amount recognised in CFHR is removed and included in the initial cost of the non-financial asset/liability. This is not accounted for as a reclassification.
- For all other forecast transactions, the amount recognised in CFHR is reclassified to profit or loss in the periods when the cash flows are expected to affect profit or loss.

(ii) Fair value hedge

Hedge of exposure to fair value variability in an asset, liability, or unrecognised firm commitment (or part thereof i.e. component), attributable to a risk that could affect profit or loss.

Recognition

- Gain or loss on hedging instrument: recognised in profit or loss (unless the hedging instrument is an equity instrument measured at fair value through OCI, then recognised in OCI).
- Gain or loss on hedged item: recognised in profit or loss (unless the hedged item is an equity instrument measured at fair value through OCI, then recognised in OCI).

(iii) Hedges of a net investment in a foreign operation

Hedge of an entity's interest in the net assets of a foreign operation.

Recognition

- Hedge effectiveness is recognised in OCI
- Hedge ineffectiveness is recognised in profit or loss
- Upon disposal of the foreign operation, accumulated amounts in equity are reclassified to profit or loss.

NZ IFRS 9: FINANCIAL INSTRUMENTS (6 OF 6)

INTEREST RATE BENCHMARK REFORM: AMENDMENTS TO NZ IFRS 9, NZ IAS 39 AND NZ IFRS 7

In response to the uncertainty arising from the phasing out of Inter Bank Offered Rates (IBORs), the XRB has published Interest Rate Benchmark Reform: Amendments to NZ IFRS 9, NZ IAS 39 and NZ IFRS 7 ('IBOR phase 1').

The amendments affect specific hedge accounting requirements in NZ IFRS 9:

- When assessing whether a forecast transaction is highly probable or whether a hedged future cash flow is expected to occur assume that IBOR-based contractual terms are not altered as a result of IBOR Reform.
- When making prospective effectiveness assessments (an economic relationship under NZ IFRS 9), assume that the IBOR-based contractual cash flows from the hedging instrument and the hedged item are not altered as a result of IBOR Reform
- As long as a non-contractually specified IBOR risk component meets the separately identifiable requirement at inception of the hedge accounting relationship, hedge accounting should be continued
- When an entity frequently resets a hedge accounting relationship in a macro hedge, the non-contractually specified IBOR risk component only needs to meet the separately identifiable requirement at the point the hedged item was initially designated within that hedge accounting relationship

The amendments are to be applied retrospectively for accounting periods beginning on or after 1 January 2020 with earlier application permitted. However, it is important to note that retrospective application in this context applies only to:

- Those hedge accounting relationships that existed at the beginning of the reporting period in which the amendments have first been applied (or were designated thereafter), and
- Amounts recognised in the cash flow hedge reserve that existed at the beginning of the reporting period in which the amendments have first been applied.

The amendments are limited in time until the uncertainty arising from interest rate benchmark reform is no longer present. Phase 2 (see below) begins once Phase 1 is completed.

INTEREST RATE BENCHMARK REFORM PHASE 2: AMENDMENTS TO NZ IFRS 9, NZ IAS 39, NZ IFRS 7, NZ IFRS 4 AND NZ IFRS 16

In response to the effects of interest benchmark rates being replaced, the XRB has published Interest Rate Benchmark Reform: Amendments to NZ IFRS 9, NZ IAS 39, NZ IFRS 7, NZ IFRS 4 and NZ IFRS 16 ('IBOR phase 2'). Phase 1 of the reliefs end once phase 2 commences, which is when the uncertainty relating to interest rate benchmark reform ceases to exist and changes to contractual cash flows take effect.

The amendments affect specific accounting requirements, primarily relating to the subsequent measurement requirements of NZ IFRS 9 and NZ IFRS 16. The amendments modify the requirements of these standards when there is a change in the basis for determining contractual cash flows of financial assets, financial liabilities and lease liabilities. Interest rate benchmark reform may result in changes to these contractual cash flows, where absent these amendments, an immediate effect would be recorded in profit or loss when the change in contractual cash flows occurs. This is because the revised contractual cash flows would be discounted at the original effective interest rate of the related financial instrument or lease liability. Instead, to the extent that a change in interest rate arises directly as a result of interest rate benchmark reform, this is reflected in a revised effective interest rate meaning that no gain or loss arises.

The amendments also modify the hedge accounting requirements of NZ IFRS 9. Hedge relationships addressed by the Phase 1 amendments may have their designated hedging relationships revised once the uncertainty relating to interest rate benchmark reform is resolved, without a requirement for hedge accounting to be discontinued.

The amendments are to be applied retrospectively for accounting periods beginning on or after 1 January 2021 with earlier application permitted.