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Mr John Stanford
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International Federation of Accountants
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Submitted to: www.ifac.org

Dear John

ED 62 *Financial Instruments*

Thank you for the opportunity to comment on ED 62 *Financial Instruments*. The ED was exposed for comment in New Zealand and some New Zealand constituents may comment directly to you.

We support the IPSASB's work to develop an IPSAS based on IFRS 9 *Financial Instruments* and are generally supportive of the proposals in the ED.

In New Zealand we have already issued an interim PBE Standard based on IFRS 9, pending the completion of the IPSASB's project. Our main reason for issuing PBE IFRS 9 *Financial Instruments* was to allow groups that comprise both for-profit entities, which apply NZ IFRS, and public benefit entities (PBEs), which apply PBE Standards, to align the classification and measurement of financial instruments and thereby avoid consolidation issues. The other reason was to allow PBEs to adopt the new hedging requirements in IFRS 9 now, rather than waiting another year or two. PBE IFRS 9 is available for early adoption by all PBEs, but it is not mandatory until 1 January 2021, by which time we hope to have issued a PBE Standard based on a new IPSAS.

We consider that this project is important for international public sector reporting. Some public sector entities have complex financial instruments and are active in international capital markets. Depending upon the regulatory framework in a jurisdiction, some public sector entities might be reporting in accordance with IFRS® Standards and others in accordance with IPSASs. Capital markets work more efficiently when information is readily accessible and comparable. The proposed new standard will assist comparisons between entities and will allow governments to more easily

benchmark their financial instrument portfolios internationally.

We also consider that there are other, broader, reasons for convergence in this area. The body of knowledge that has developed as entities work through the implementation of IFRS 9 may assist public sector entities applying the proposed new IPSAS. The transfer of knowledge and skills between sectors underscores the benefits of convergence for this topic.

Our responses to the Specific Matters for Comment on ED 62 are set out in Appendix 1 to this letter.

Our comments on other matters are set out in Appendix 2 to this letter.

We would like to acknowledge the usefulness of the comparison between IFRS 9 and ED 62 in considering the proposals in the ED.

If you have any queries or require clarification of any matters in this letter, please contact Joanne Scott (Joanne.Scott@xrb.govt.nz) or me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Kimberley Crook', written in a cursive style.

Kimberley Crook
Chair – New Zealand Accounting Standards Board

Appendix 1 Specific Matters for Comment

Specific Matter for Comment 1:

Consistent with the relief provided in IFRS 9, the IPSASB has agreed in [draft] IPSAS [X] (ED 62) to allow an option for entities to continue to apply the IPSAS 29 hedging requirements. Do you agree with the IPSASB's proposal?

We agree with the IPSASB's proposal to allow entities to continue to apply the IPSAS 29 *Financial Instruments: Recognition and Measurement* hedging requirements as we consider that alignment with IFRS 9 on this matter is important. Although we support the proposed changes to hedge accounting and understand that the IASB's reasons for permitting this option may not be relevant for a number of public sector entities, we do not think there are any pressing reasons to withdraw the option.

We note the following arguments for keeping the option.

- In some jurisdictions, such as New Zealand, there may be 'mixed groups' that include entities applying IFRS Standards and entities applying IPSASs, or standards based on IPSASs. Within these groups some entities may have elected to continue using the hedging requirements in IAS 39 *Financial Instruments: Recognition and Measurement*. Limiting the option in the IPSAS equivalent to IFRS 9 would impose additional costs on such groups.
- Some public sector entities may be using the macro hedging requirements in IPSAS 29. The option is needed so that such entities can continue to apply those requirements.
- If regulators or central agencies within a jurisdiction have concerns about the option (in terms of comparability or consolidation costs), they have the choice of limiting the use of the option in that jurisdiction.
- The option might reduce the costs of transitioning to the new standard. Any review of strategies, processes and systems for compliance with new requirements takes time and money, even if few changes are required as a result of that review.

We acknowledge that allowing options in accounting standards can be undesirable but, in this case, we do not think that continuing to allow entities to apply the hedging requirements in IPSAS 29 would create a problem. There is a general consensus that the new hedging requirements are more appropriate and flexible than the previous requirements. One would therefore expect most entities engaged in hedging to elect to apply the new hedging requirements. The exception would be those entities that are currently applying the macro hedging requirements in IPSAS 29, and who will need the option until new macro hedging requirements have been developed.

In order to have a record of significant issues considered during the development of this standard, we think that the Basis for Conclusions should explain why the IPSASB sought feedback on this issue.

Specific Matter for Comment 2:

The IPSASB recognizes that transition to the new standard [draft] IPSAS [X] (ED 62) may present implementation challenges as a result of the number of significant changes proposed. Therefore, the IPSASB intends to provide a 3-year implementation period until [draft] IPSAS [X] (ED 62) is effective (early adoption will be permitted). Do you agree with the proposed 3-year implementation period before [draft] IPSAS [X] (ED 62) becomes mandatory? Please explain.

We support the proposal to allow a 3-year implementation period.

Entities will need to undertake impact assessments and develop a plan to implement the proposed new standard. In particular, the following aspects of implementing the proposed new requirements could be complex and time consuming:

- (a) the reassessment of the classification of financial instruments;
- (b) the development of models and systems to capture the information required by the expected credit loss model;
- (c) the reassessment of hedging relationships; and
- (d) identifying differences in disclosure requirements and developing models and systems to obtain the information required by the disclosures. An entity will need to think about the impact of new disclosure requirements from the beginning of its implementation period.

We note that the IASB issued the complete version of IFRS 9 *Financial Instruments* in July 2014 with an effective date of 1 January 2018. Although this timeframe appeared to be relatively generous, our impression is that many entities have needed this much time. In addition, some of the public sector specific issues will take time to work through.

Although implementation of IFRS 9 may have been a more complex exercise for financial institutions, other types of entities have also faced implementation challenges.

Specific Matter for Comment 3:

Do you agree with the proposed transition requirements in paragraphs 153–180, consistent with those provided in IFRS 9? If not, what specific changes do you recommend and why?

We agree with the proposed transition requirements in paragraphs 153–180.

Appendix 2: Comments on Other Matters

In this appendix we comment on the following matters:

- sale of future flows arising from a sovereign right;
- prepayment features with negative compensation;
- initial measurement;
- valuation of unquoted equity instruments;
- valuing financial guarantees through a non-exchange transaction; and
- concessionary loans – disclosures.

Sale of future flows arising from a sovereign right

We understand that the IPSASB wanted to explicitly address the possibility that transactions involving the sale of future flows arising from a sovereign right could give rise to financial liabilities.

We suggest that the IPSASB limit any such guidance to the financial liabilities arising from such transactions. An entity should assess the treatment of the revenue from such transactions by applying the relevant revenue standard. We are not sure why the IPSASB considers that the relevant revenue standard would always be IPSAS 9 and would welcome further explanation of the matters considered in the Basis for Conclusions. If the IPSASB wants to specify requirements for the recognition of revenue from such transactions we consider this would more appropriately be located in the relevant revenue standard(s).

We have suggested some changes to paragraphs AG33 and BC13 for consideration by the IPSASB. We think these changes would clarify that paragraph AG33 is dealing with the sale of future flows that have not been previously recognised as assets, rather than the securitisation of existing financial assets (which would be subject to the usual derecognition requirements in the proposed standard).

AG33. In the public sector, securitization schemes may involve a sale of future flows arising from a sovereign right, such as a right to taxation, that have not previously been recognized. An entity recognizes the revenue arising from ~~Consideration received for such sale transactions shall be accounted for~~ in accordance with the relevant standard ~~IPSAS 9. Such transactions may give rise to~~ Public Sector entities shall also consider if the securitization arrangement gives rise to financial liabilities as defined in IPSAS 28. Examples of such financial liabilities may include but are not limited to borrowings, financial guarantees, liabilities arising from a servicing or administrative contract, or payables relating to cash collected on behalf of the purchasing entity. Financial liabilities shall be recognized when the entity becomes party to the contractual provisions of the instrument in accordance with paragraph 10 and classified in accordance with paragraph 45 and 46. The financial liabilities shall be initially recognized in accordance with paragraph 57, and subsequently measured in accordance with paragraphs 62 and 63.

Sale of Future Flows Arising from a Sovereign Right

BC13. In the public sector, securitization schemes may involve a sale of future flows arising from a sovereign right, such as a right to taxation. The IPSASB agreed that it would be helpful to acknowledge that such transactions may give rise to financial liabilities and agreed to include paragraph AG33. The IPSASB ~~noted~~ agreed that revenue from the sale of future flows arising from a

sovereign right ~~would be~~ is a transaction that should be accounted for in accordance with the relevant ~~revenue standard~~ guidance. The IPSASB agreed that financial liabilities may arise from a securitization arrangement. Examples may include but are not limited to borrowings, financial guarantees, liabilities arising from servicing or administrative or payables relating to when the public sector entity (originating entity) collects cash flows and passes these along to a third party. The IPSASB considered whether additional application guidance to address such scenarios was required, ~~but~~ and concluded that sufficient guidance exists in the Standard to address ~~all other aspects of~~ any financial instruments arising from those transactions.

Prepayment features with negative compensation

The IASB has recently issued *Prepayment Features with Negative Compensation* (Amendments to IFRS 9).

Respondents to the IASB's exposure draft indicated that legislation in some countries gives borrowers protective rights that can give rise to negative compensation. We would expect that in jurisdictions where such rights exist, they could also be relevant to public sector entities. Although we are not aware of any public sector or not-for-profit entities in New Zealand for which these proposals would be relevant, we think that the IPSASB should also address this issue. We think it would be better to align these requirements now, rather than making amendments in the future.

Initial measurement

We generally agree with how the IPSASB has combined the public sector specific measurement guidance in IPSAS 29 with the requirements of IFRS 9. However, we disagree with the inclusion of paragraph AG117 (which is based on IFRS 9 paragraph B5.1.2A). We recommend that paragraph AG117 is omitted (because the matters addressed in it are already addressed in paragraph AG147) and we recommend that paragraph AG115 refer to paragraph AG147. This matter needs to be addressed as ED 62 paragraph AG 117 is inappropriately linking the guidance in paragraph AG115 (dealing with situations in which there is another component to the transaction) and the guidance in paragraph AG117 (on the prohibition of day one gains/losses).

A more detailed explanation of our reasons for disagreeing with the inclusion of paragraph AG117 (and the history of the related guidance paragraphs) is set out below.

Paragraph AG115 deals with accounting for a separate component of a transaction. The equivalent guidance in IPSAS 29 (paragraph AG82) originally came from IAS 39 (paragraph AG64) and was included in IPSAS 29 with only a few terminology changes. This guidance explains that when part of the consideration given or received is for *something other than the financial instrument* (as is the case with concessionary loans), the fair value of the financial instrument may need to be estimated.

IAS 39 (paragraphs AG74–AG76) and IPSAS 29 (paragraphs AG106–AG112) dealt with the application of valuation techniques and other situations in which there may be a difference between the fair value of a financial instrument and the transaction price. These paragraphs were intended to prohibit or limit day 1 gains/losses in other circumstances (ie if there was not another component to the transaction). These paragraphs were almost identical in the two standards. In particular, IPSAS 29 (paragraph AG108), which has been carried forward into ED 62 as paragraph AG147, includes the following sentence about the best estimate of the fair value of a financial instrument on initial recognition.

... The best evidence of the fair value of a financial instrument at initial recognition, in an exchange transaction, is the transaction price (i.e. the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.

We support the inclusion of paragraph AG147 in ED 62. However, we note that IPSAS 29 paragraph AG108 was based on IAS 39 paragraph AG76. That paragraph was subsequently amended by IFRS 13 *Fair Value Measurement* and then carried forward into IFRS 9 as paragraph B5.1.2A (which is the paragraph on which ED 62 paragraph AG117 is based). This means that ED 62 is dealing with the same issue twice (once using post-IFRS 13 wording based on what is currently in IFRS 9, and once using pre-IFRS 13 wording from IAS 39/IPSAS 29).

Given that the IPSASB has not developed a standard based on IFRS 13, we think ED 62 paragraph AG117 should be deleted and paragraph AG147 should be kept. We also think paragraph AG115 of the ED should refer to paragraph AG147.

If the IPSASB agrees with our suggestions, the following comment about paragraph AG117 is not relevant. However, if the IPSASB wants to keep paragraph AG117 (which would involve rewriting parts of the measurement guidance) we note that paragraph AG117 should not refer to paragraph AG115. The equivalent paragraph in IFRS 9, paragraph B5.1.2A, refers to paragraph 5.1.1A (which is not reproduced in ED 62).

Valuation of unquoted equity instruments

We support the development of illustrative examples on the valuation of unquoted equity instruments. However, we think that further guidance to assist entities in determining the fair value of non-cash-generating investments would be helpful.

The guidance and examples in the ED focus more on measuring the fair value of investments in cash-generating entities. In the public sector there can be situations where the investee is carrying out activities that support the investor's public policy objectives. This raises the issue of whether the fair value of such investments should be determined solely by reference to expected cash flows, as in Example 25, or whether fair value assessments should also take account of other factors, such as the service potential associated with such investments. Example 27 touches on the possibility that the transaction price may not be representative of fair value at the measurement date, but it does not provide any guidance on estimating the fair value of the non-controlling equity interest.

Valuing financial guarantees through a non-exchange transaction

ED 62 paragraph AG133 is identical to IPSAS 29 paragraph AG97 – it refers to the principles in IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*. By contrast, in developing PBE IFRS 9, we chose to align the measurement of financial guarantees issued as part of a non-exchange transaction with IFRS 9's requirements for the measurement of financial guarantees. It is not clear to us if the IPSASB has deliberately kept the reference to IPSAS 19 rather than referring to the amount of the loss allowance determined in accordance with section 5.5 of IFRS 9, and if so, why.

If the reference to IPSAS 19 in paragraph AG133 is intentional, we suggest that the IPSASB outlines its rationale for retaining this requirement in the Basis for Conclusions.

We have shown ED 62 paragraph AG133 and PBE IFRS 9 paragraph B5.1.2M below.

Extract from ED 62

AG133. If no reliable measure of fair value can be determined, either by direct observation of an active market or through another valuation technique, an entity is required to apply the principles of IPSAS 19 to the financial guarantee contract at initial recognition. The entity assesses whether a present obligation has arisen as a result of a past event related to a financial guarantee contract whether it is probable that such a present obligation will result in a cash outflow in accordance with the terms of the contract and whether a reliable estimate can be made of the outflow. It is possible that a present obligation related to a financial guarantee contract will arise at initial recognition where, for example, an entity enters into a financial guarantee contract to guarantee loans to a large number of small enterprises and, based on past experience, is aware that a proportion of these enterprises will default.

Extract from PBE IFRS 9

B5.1.2M If no reliable measure of fair value can be determined, either by direct observation of an active market or through another valuation technique, an entity is required to measure the financial guarantee contract at the amount of the loss allowance determined in accordance with Section 5.5.

Concessionary loan disclosures

We support the proposal to split the disclosures about concessionary loans required by IPSAS 30 into two paragraphs (being paragraphs 37 and 37A). We have a couple of suggestions in relation to these paragraphs (our suggestions are shown as shaded text in paragraphs 37 and 37A below).

Not all loans to developing countries, small farms etc are concessionary. They are concessionary when there is an interest or principal discount. We suggest a change to the second sentence of paragraph 37. If you agree with this suggestion, an equivalent change would be required in ED 62 paragraph AG118.

Although paragraph 37(c) and 37A(c) require disclosure of the purpose and terms of the loans, we consider that it would be helpful to explicitly require disclosure of the concessionary terms. We suggest adding the words “including the nature of the concession” to these paragraphs.

Concessionary Loans

37. Concessionary loans are granted by entities on below market terms. Examples of concessionary loans that commonly have below market terms granted by entities include loans to developing countries, small farms, student loans granted to qualifying students for university or college education, and housing loans granted to low income families. For concessionary loans granted and measured at amortized cost in accordance with paragraph 40 of [draft] IPSAS [X] (ED 62), *Financial Instruments* an entity shall disclose:

- (a) A reconciliation between the opening and closing carrying amounts of the loans, including:
 - (i) Nominal value of new loans granted during the period;
 - (ii) The fair value adjustment on initial recognition;
 - (iii) Loans repaid during the period;
 - (iv) Impairment losses recognized;
 - (v) Any increase during the period in the discounted amount arising from the passage of time; and

- (vi) Other changes.
 - (b) Nominal value of the loans at the end of the period;
 - (c) The purpose and terms of the various types of loans, including the nature of the concession; and
 - (d) Valuation assumptions.
- 37A. For concessionary loans measured at fair value in accordance with paragraph 41 or 43 of [draft] IPSAS [X] (ED 62), *Financial Instruments* an entity shall disclose:
- (a) A reconciliation between the opening and closing carrying amounts of the loans, including:
 - (i) Nominal value of new loans granted during the period;
 - (ii) The fair value adjustment on initial recognition;
 - (iii) Loans repaid during the period;
 - (iv) The fair value adjustment during the period (separate from initial recognition); and
 - (vi) Other changes.
 - (b) Nominal value of the loans at the end of the period;
 - (c) The purpose and terms of the various types of loans, including the nature of the concession; and
 - (d) Valuation assumptions.

Editorial comments

We have identified some minor editorial matters for consideration in finalising the standard.

Paragraph	Comment
3	First reference to IPSAS 9 – add title.
84	... favourable <u>favorable</u> ...
Appendix A: Application Guidance	
AG115	In heading immediately above paragraphs AG115 ... (paragraphs 57–58)
AG133	...The entity assesses whether a present obligation has arisen as a result of a past event related to a financial guarantee contract, whether it is probable that such a present obligation will result in a cash outflow in accordance with the terms of the contract and whether a reliable estimate can be made of the outflow. It is possible that a present obligation related to a financial guarantee contract will arise at initial recognition where, for example, an entity enters into a financial guarantee contract to guarantee loans to a large number of small enterprises and, based on past experience, is aware that a proportion of these enterprises will default.
Appendix B – Hedges of a Net Investment in a Foreign Operation	
B2	...in which investments such as associates or joint venters <u>ventures</u> are accounted...
Appendix D: Amendments to other IPSASs	
IPSAS 30	Page 195 Amendments to IPSAS 30, Financial Instruments: Presentation <u>Disclosures</u>
IPSAS 30	Page 212 Nature and Extent <u>Extent</u> of Risks Arising from Financial Instruments
Illustrative Examples	
IE7	Footnote 8: The security on the loan affects the loss that would be realized...
IE82	This example refers to Entity V’s business model rather than Entity V’s management model.
IE142	Example 18 Amortisation <u>Amortization</u> of CFHR (and a few subsequent uses)
IE153	Inconsistent use of % or percent in italicised explanations (see journal 2) Inconsistent reference to capital repaid (journal 4 refers to capital repaid but the other journals do not) Example 20 uses brackets around the calculations but example 21 doesn’t.
IE161	The journal entries to account for the concessionary loan when classified at amortized cost <u>fair value through surplus/deficit</u> are as follows: Inconsistent use of % or percent in italicised explanations
Implementation Guidance	
D.2.3	In final journal Realisation <u>Realization</u> gain
G.2	<i>G.2 Concessionary Loans and “Solely Payments of Principal and Interest” Evaluation</i> Can a concessionary loan satisfy the SPPI condition <u>criteria</u>