14 October 2016

Level 1, 100 Molesworth Street
Thorndon, Wellington
PO Box 99, Wellington 6140
04 496 3099
www.auditnz.govt.nz

Warren Allen
Chief Executive
External Reporting Board
PO Box 11250
Manners St Central
Wellington 6142
Email: submissions@xrb.govt.nz

Dear Warren

Exposure Draft NZASB 2016-7 PBE IFRS 9 *Financial Instruments*

We appreciate the opportunity to comment on Exposure Draft NZASB 2016-7 PBE IFRS 9 *Financial Instruments* (the exposure draft). Thank you for extending the time period we had available to make this submission from 30 September to 14 October.

We are pleased that the New Zealand Accounting Standards Board (NZASB) is developing a public benefit entity (PBE) standard based on IFRS 9 to be available for voluntary adoption by PBEs when NZ IFRS 9 *Financial Instruments* becomes effective in the for-profit sector. We consider that having a PBE standard based on IFRS 9 available when NZ IFRS 9 becomes mandatory is important for mixed groups as it will help reduce the compliance costs associated with consolidating for-profit entities.

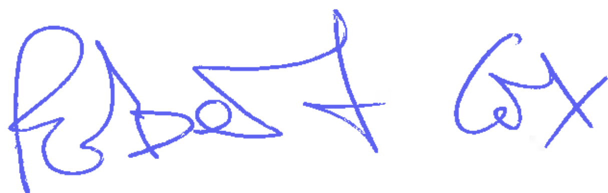
However, we consider the NZASB needs to provide further guidance on the initial classification and the application of the expected loss model to concessionary loans originated by PBEs. We are concerned that the proposed requirements, which have been developed with commercial lending practices in mind, are not clear enough in how they should be applied to concessionary loans.

Our detailed responses to the Questions for Respondents outlined in the *Invitation to Comment* are attached. Please note that our comments primarily focus on PBEs in the public sector.

Our comments on the exposure draft are a result of collaboration between staff at Audit New Zealand and the Office of the Auditor-General.

If you have any questions about our submission, please phone me on 021 222 6107 or email me at robert.cox@auditnz.govt.nz. Alternatively, you can contact Brett Story on 021 222 6247 or e-mail at brett.story@auditnz.govt.nz.

Yours sincerely



Robert Cox
Director and Head of Accounting

Our responses to the questions in the Invitation to Comment

1 **Do you support the NZASB's proposal to issue a PBE Standard based on IFRS 9 in advance of the IPSASB completing its project on financial instruments, taking into account the factors discussed in the *PBE Policy Approach*? If not, please explain why not and indicate any alternative course of action that you think would be more appropriate.**

Yes, we support the NZASB's proposal.

We consider this a reasonable response given the complexity and significance of financial instrument accounting by both PBEs and for-profits. It is likely significant costs would be incurred by some mixed group entities should a PBE based IFRS 9 not be developed.

We also note that IFRS 9 is generally viewed as an improvement to IAS 39. The development of a PBE standard based on IFRS 9 will provide PBEs with flexibility on whether to take advantage of those improvements at an earlier stage.

2 **If a PBE Standard based on IFRS 9 were to be issued by the end of 2016, and you are the head of a mixed group or a member of a mixed group:**

(a) do you think it is likely that you or any PBEs within the mixed group would wish to early-adopt PBE IFRS 9; and

(b) if so, do you think that the expected issue date of late 2016 would provide sufficient lead-in time for a PBE within a mixed group to voluntarily adopt the proposed PBE Standard?

While we have not engaged with public entities on this question, we expect PBE groups with material for-profits would consider early adopting a PBE standard based on IFRS 9 to avoid mixed group reporting issues.

Yes, we consider the planned timing provides sufficient lead-in time. However, it is also important that the NZASB carefully considers the issues raised by constituents and that it takes the time necessary to address the issues raised.

3 **Do you agree with the modifications made by the NZASB in developing the proposed PBE Standard? If not, please explain why not and identify what you think would be more appropriate.**

We have no concerns with the modifications that have been made that are largely PBE specific guidance carried forward from PBE IPSAS 29.

We however consider the NZASB needs to provide further guidance on the initial classification and impairment requirements of the proposed standard to concessionary loans to ensure consistent application for such loans. These concerns are discussed in further detail in the Further Comments section below.

Further, the proposed standard continues to scope out receivables and payables that are non-contractual in nature, such as tax related receivables and payables. This means there continues to be no clear requirements on how to subsequently measure and impair non-contractual receivables and payables. To ensure consistency, we consider it important that clear requirements be developed on the subsequent measurement and impairment of non-contractual receivables and payables. We believe that the IPSASB is considering this issue as part of its revenue and non-exchange expenses projects.

4 **Do you agree with the proposed RDR concessions in relation to PBE IPSAS 30 (refer Appendix D of the Exposure Draft)? If you disagree, please provide reasons and indicate what concessions you consider would be appropriate.**

We agree with the RDR concessions provided in relation to the proposed new or amended disclosures.

5 **Do you agree with the proposal that the effective date of the proposed PBE IFRS 9 be 1 January 2021, with early adoption permitted (bearing in mind the NZASB's intention to defer the effective date of PBE IFRS 9 until a future IPSAS based on IFRS 9 is effective)?**

Yes, we agree with the effective date and the option to early adopt. We would expect the NZASB to defer the mandatory effective date should the IPSASB be delayed in issuing their equivalent to IFRS 9.

6 **Do you have any other comments on the Exposure Draft?**

Yes, see below.

Additional comments – Concessionary loans

Many entities in the public sector originate loans to entities or individuals to help achieve a social objective, rather than for making a return on the loan. These loans can be concessionary in nature. The features of concessionary loans can include:

- Below market interest rates, including no interest.
- Little or no covenants or other loan terms that can give rise to a default event during the term of the loan prior to maturity.
- The repayment of principal and/or interest can be event driven rather than time driven. This can result in the loan balance being outstanding for many decades. For example, principal is only repaid if an individual earns income above a specified threshold or an entity has sufficient surplus funds, sells an asset, or ceases to provide a service.
- The granting of the loan is not assessed on the credit worthiness of the individual or entity, rather it is the purpose for which the funds are to be used that is determinative. Loans can be provided to individuals or entities that would not be able to obtain a loan by commercial means and it may be reasonably expected that the loan will not be repaid in full when originated.

- The credit worthiness of the individual or entity is not assessed on an on-going basis and a change in credit worthiness would be difficult to assess over time. The loan monitoring would however focus on whether events have taken place that would require the individual or entity to repay loan monies.

We discuss below some of the concerns we have on how the proposed requirements would apply to concessionary loans.

1 - Classification of concessionary loans for subsequent measurement purposes

A financial asset is subsequently measured at amortised cost only if both of the following conditions are met:

a) The financial asset is held with a business model whose objective is to hold financial assets in order to collect contractual cash flows; and

b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding.

As already noted, a feature of concessionary loans could be that the loan is interest free and the payment terms may be linked to an event rather than a fixed date (i.e they may not be specified).

Without further guidance in the proposed standard, we think the application of the SPPI test above to concessionary loans is unclear and could be interpreted differently.

We are concerned that the words in the SPPI test could be interpreted to not be met for some concessionary loans because:

- There is no interest charged, based on a literal reading of "principal and interest".

- Specified date could mean the arrangement needs to refer to an actual repayment date.

Accepting such interpretations would result in many concessionary loans being measured at fair value, which results in more timely and costly accounting for no benefit.

We recommend the NZASB add further guidance to the Application Guidance of Appendix B to clarify how the SPPI test shall be applied to concessionary loans. In particular, we consider that further guidance could be provided for concessionary loans where a repayment date is not specified upfront. For example, the reference to specified date could be interpreted in a broad context. Provided the arrangement documents the events that trigger the repayment of principal that enables a repayment time to be estimated, this indirectly specifies the date of the principal payment, albeit without referring to an actual date in the loan documentation.

2 – Applying the expected loss model to concessionary loans

The expected loss model of the proposed PBE IFRS 9 is based on the model of NZ IFRS 9. The expected loss model of NZ IFRS 9 has been developed with commercial entities in mind that enter into loan arrangements on commercial terms and monitor their loan books in a commercial manner. Given this, we think there will be challenges in applying this commercial framework to non-commercial loans.

Given the non-commercial nature of concessionary loans, we consider further guidance needs to be developed in determining the appropriate expected loss approach that applies to such loans during the term of the loans.

Firstly, we expect it could be difficult to determine when there has been a significant increase in credit risk since origination of the loan as PBEs do not manage their concessionary loans on the basis of credit risk and may have little information to make such judgements. Additionally, in some cases, the non-collection of all or part of the loan may also only become evident when the loan is repayable at maturity (as there were no payments due prior to maturity to inform of a possible default at maturity) or when the event that triggers repayment does not occur.

Secondly, it is not clear when a concessionary loan is considered credit impaired at origination. The proposed standard contemplates that a loan may be acquired or issued with incurred credit losses at initial recognition, referred to as a "credit-impaired financial asset". Correctly classifying an instrument as credit impaired at initial recognition is important because the impairment model for such loans is subsequently always based on life-time credit losses and interest revenue is recognised based on the amortised cost balance ("net interest").

The proposed standard defines credit loss as:

A credit loss is the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls), discounted at the original effective interest rate (or credit adjusted effective interest rate for purchased or originated credit-impaired financial assets).

The credit impaired financial asset examples also includes the following example of evidence that a final asset is credit impaired:

..(b) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lenders would not otherwise consider.

When a PBE initially recognises a concessionary loan at fair value, in addition to discounting at a commercial discount rate, it also needs to consider whether it would recover all of the loan advanced in estimating fair value.

The very nature of concessionary loans can mean for some loans it is reasonably certain at loan origination that the loan principal will not be fully recovered and this is reflected in the write-down to fair value at initial recognition. This could arise from the nature and objectives of the counterparties, the repayment terms, and repayment experience from other borrowers, rather than from the occurrence of specific credit related event(s) of the types listed in the credit-impaired financial asset definition.

We consider it unclear when a concessionary loan should be considered credit impaired if the principal amount of the loan is not expected to be fully collected at origination when considering the credit loss and credit impaired definitions. It is also unclear whether this assessment would apply at the individual borrower level or at a portfolio level.

We recommend guidance be added to the proposed standard to clarify when concessionary loans may be credit impaired at initial recognition by adding PBE-based examples to the credit impaired definition or the addition of application guidance to Appendix B.

Conclusion on concessionary loans

The issues we have discussed above highlight there could be challenges in determining the appropriate impairment model to apply to concessionary loans, both at origination and subsequently.

While we have included recommendations for the matters discussed above, the NZASB needs to consider the impairment model for concessionary loans more holistically. A possible solution could be to develop a single approach to the impairment of concessionary loans.

Applying a single impairment model to concessionary loans would have the main advantage of simplifying the impairment accounting and avoiding various interpretation issues that are likely to be encountered in practice.

We also refer to footnote 6 to paragraph 5.5.13:

[6] A purchased or originated credit-impaired financial asset is distinguished from a concessionary loan (see B5.1.1A-B5.1.2G).

We think this footnote and related application guidance helps clarify that a loan with a concessionary interest rate is not credit impaired due to a concessionary interest rate. However, it is unclear whether it implies that all concessionary loans, including those where the principal is not expected to collected when originated, are precluded from being classified as credit impaired at origination.

We also note that the footnote reference to paragraph B5.1.1A needs updating to B5.1.2A