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Warren Allen
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Dear Warren

IPSASB Exposure Draft 62 *Financial Instruments*

We appreciate the opportunity to comment to the NZASB on the IPSASB's Exposure Draft 62 *Financial Instruments* (ED 62).

We support the IPSASB developing a new financial instruments standard based on IFRS 9. We consider it important that the financial instrument standards applied by both public benefit and for-profit entities are consistent. However, it is important that sufficient guidance is provided for financial instruments that are unique in the public sector, such as concessionary loans and equity investments in public sector entities that are non-cash-generating.

Our responses to the IPSASB's Specific Matters for Comment are attached. We also comment on other matters.

We will also provide a separate submission to the IPSASB on ED 62.

In preparing this submission, we have consulted with our colleagues at the Office of the Auditor-General.

If you would like to discuss any of our comments, please phone me on 021 222 6107 or email me at robert.cox@auditnz.govt.nz, or contact Brett Story on 021 222 6247 or email at brett.story@auditnz.govt.nz.

Yours sincerely



Robert Cox
Head of Accounting

Our comments on ED 62 Financial Instruments

- 1 **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?**

Yes, we agree with this proposal. Given the complexities of hedge accounting, we consider it important that the hedge accounting transition requirements of ED 62 are the same as those provided in IFRS 9.

- 2 **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.**

Yes, we agree with this proposal, provided early adoption is permitted. We expect a 3-year implementation period should provide sufficient time for entities to prepare and adopt a new financial instruments standard. A shorter-time period maybe too challenging for some entities that need to implement new or amended systems and processes in transitioning to a new financial instruments standard.

- 3 **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?**

Yes, we agree with this proposal. Given the complex transitional provisions, we consider it important that the transitional provisions of ED 62 are consistent with those provided in IFRS 9.

- 4 **Other comments on ED 62**

Concessionary loan guidance: Loans at nil interest

Paragraph G2 provides guidance that a concessionary loan can satisfy the SPPI criteria when the payments of the loan, based on its fair value determined at initial recognition, reflect solely payments of principal **and** interest.

a) A common feature of concessionary loans is that no interest is charged on the loan.

We consider the guidance in paragraph G2 should be explicit that a concessionary loan with a nil interest rate is not precluded from satisfying the SSPI criteria due to that feature. Without such additional guidance, the first paragraph of G2 could be interpreted different ways in respect of a concessionary loan at a nil interest rate due to the reference to "**and** interest".

We suggest the following guidance be added to G2 directly after the first paragraph:

"A concessionary loan at a nil interest rate is not precluded from satisfying the SPPI criteria due to that feature".

b) We do not find the paragraph G2 guidance sufficiently clear whether the SPPI test is met for loans where the timing of repayment of principal and interest is contingent on future income levels or financial circumstances of the borrower. We note useful guidance on this has been inserted into paragraph AG63 and we recommend that this be repeated in paragraph G2 or at least a cross-reference from G2 to AG 63 be provided.

Concessionary loan guidance: Fair value through surplus/deficit illustrative example

Scenario 2 of illustrative example 21 illustrates the accounting for a student loan at fair value through profit and loss. In this example, the loan does not satisfy the SPPI criteria because the lender has the ability to call the loan at any time for an amount that does not substantially reflect payment of outstanding principal and interest.

Prima facie, it appears unrealistic that a government entity would provide an on demand loan to a student. If the IPSASB is not aware of such a student loan scheme in practice, we strongly recommend this example be removed and it be replaced with an example more closely aligned with an actual student loan scheme, such as New Zealand's where loan repayments are contingent on the borrower's income generation.

If the IPSASB is aware there is a student loan scheme similar to that in scenario 2 where repayments are on demand by the lender, we recommend that an additional scenario 3 be added. This additional example should illustrate the accounting for a student loan where payments are contingent on the borrower's income generation.

Valuation of unquoted equity instruments

The IPSASB has inserted new fair value measurement guidance for unquoted equity instruments via illustrative examples 23 to 26.

We note this new guidance illustrates how an entity may apply different valuation techniques in measuring the fair value of investments in private companies that appear to be cash-generating in nature.

While this additional guidance is welcomed, we consider the guidance is deficient as it does not address how public sector entities estimate the fair value of equity investments in unlisted non-cash-generating public sector entities that are not subsidiaries, associates or joint ventures.

We consider the illustrative examples 27 to 28 also do not deal with this issue as those paragraphs provide no guidance in estimating the fair value of shares received.

Public sector entities (the investor) may transfer cash or physical assets to another public sector entity (investee) in return for shares where the investee's objective is to provide services back to the investor or to the general public, rather than to earn a commercial return on the investment. Examples include entities established to provide shared services to investors or entities established to hold and maintain non-cash-generating infrastructural assets (such as water supply assets or a regional airport). The investment is made by the investor to the investee to further the investor's economic or social objectives, rather than to generate a commercial return on the investment.

Paragraph AG125 also provides examples of investments by public sector entities in entities not intended to provide cash returns:

“such investments could include membership shares in a development bank, or equity investment in another public sector entity that provides certain social programs or services (e.g. shelters, subsidized housing, small business assistance...etc.)”

We are concerned that the Application Guidance in AG125 to AG127, together with the fair value measurement guidance in paragraphs AG145 to AG152 and the illustrative examples 23 to 26 suggest that the valuation of an unquoted investment in a non-cash-generating public sector entity must be determined in a commercial manner with the objective of estimating how much the investment could be sold for in an arm’s length transaction i.e. an exit value. Applying a commercial valuation approach to such non-cash-generating investments could result in the investment value being substantially written-down close to nil.

We consider the commercially focussed emphasis to the measurement of fair value to be inappropriate to apply to many investments in public sector entities within the scope of ED 62 as such an approach does not reflect the substance and purpose of the investment. The guidance in the ED suggests that all public sector non-commercial equity investments should be written down substantially to reflect only the value of future cash returns. We consider such an outcome inappropriate and incorrect.

The accounting resulting from a commercially focussed approach to valuation would be comparable to expensing a direct investment in infrastructural assets on the basis the carrying value is not supported by cash flows.

We therefore consider relevant guidance should be provided in measuring the fair value of non-cash-generating equity investments that reflects the substance and rationale for such investments.

If the IPSASB decides at this stage to add no further guidance in measuring the fair value of non-cash-generating equity investments in public sector entities, we recommend this issue be specifically addressed by the IPSASB’s *Public Sector Measurement* project.

Equity instruments arising from non-exchange transactions

It appears the intent of the new application guidance paragraphs AG125 to AG127 is that the non-exchange component is the difference between the consideration provided to the investee and the fair value of the shares received. If this is the intent of these new requirements, this should be made clearer.

As discussed above, we consider there is not sufficient guidance in ED 62 on estimating the fair value of non-cash-generating equity investments. These concerns equally apply in respect of the application of paragraph AG125 to AG 127. Given the non-exchange component is the difference between the fair value of the shares and the consideration provided, it is essential that sufficient fair value measurement guidance is provided to ensure an expense is not inappropriately recognised at initial recognition.

Capital subscriptions with Development Banks

Example 31 in paragraphs IE207 to IE210 provides guidance on capital subscriptions to a Development Bank. The example concludes that these are to be classified at fair value through surplus or deficit.

We note that the Public Sector Specific Financial Instruments project is dealing with similar issues, specifically the IMF quota subscriptions. We encourage the IPSASB to consider whether specific guidance on investments in development banks, such as the Asian Development Bank (ADB), is best provided as part of that project, rather than as limited non-specific guidance in ED 62. In New Zealand, the funding commitments to development banks are significant with about NZ\$5bn (excluding IMF commitments of \$2.6bn) in uncalled capital disclosed in the 30 June 2017 Financial Statements of Government.

Editorial comments

During our review of ED 62, we have noticed a small number of editorial errors. When finalising ED 62, the IPSASB staff need to carefully review the final document to ensure such errors are avoided.

For example, we identified in IE 163 100,000 CUs should be 1,000,000 CUs.