2 February 2018

Mr. Ian Carruthers
Chair
International Public Sector Accounting Standards Board
International Federation of Accountants
529 Fifth Avenue
New York, NY 10017
UNITED STATES OF AMERICA

By website submission

Dear Mr Carruthers

IPSAS 62 Financial Instruments

The Queensland Audit Office (QAO) welcomes the opportunity to comment on the draft standard.

The Queensland Auditor-General audits Queensland government departments, statutory bodies, universities, local governments, and their controlled entities.

QAO agrees that only very limited changes of substance are required to IFRS 9 Financial Instruments for the standard to be applicable in the public sector (Section 1).

We recommend clarifications in relation to:
• the interaction with IPSAS 9 and 23, and in particular, the extent to which statutory receivables are included in the proposed scope (Section 2) and apparent unintended consequences (Section 3).
• public sector examples (Section 4)
• other matters (section 5).

Yours sincerely

Brendan Worrall
Auditor-General

Enc.
cc. Kris Peach, Chair and CEO, Australian Accounting Standards Board
Section 1 - Modifications to IFRS 9

Australian standards for public sector entities are based on IFRS standards, with appropriate public sector and not-for-profit modifications. The Australian Accounting Standards Board (AASB) currently uses IPSASs as an important source for determining whether modifications are needed to IFRS standards for public sector and not-for-profit sector issues.

The AASB amended its equivalent of IFRS 9 (AASB 9) to require the initial recognition of statutory receivables at fair values. This amendment is effective a year later than AASB 9 on the commencement of the not-for-profit equivalent of IFRS 15 *Revenue from Contracts with Customers* (AASB 15) and the Australian standard for non-exchange transactions (AASB 1058 *Income for Not-for-Profit Entities*). No specific requirements have been included for the subsequent measurement of statutory receivables.

QAO notes ED62 proposes the following types of modifications to IFRS 9:

- changes to scope (for IPSAS 9 *Revenue from Exchange Transactions* and IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)*)
- changes to align with IPSAS measurement standards (in particular, the lack of a fair value standard, lack of an insurance contract standard, and the lack of the concept of other comprehensive income)
- inclusion of public sector examples
- editorial conventions (including American spelling and capitalisation of headings).

QAO also notes that the proposals are subject to future amendment from the IPSASB project on public sector specific financial instruments.

QAO agrees that very limited changes of substance to IFRS 9 are required.
Section 2 - The interaction with IPSAS 9 and IPSAS 23 - Scope

Background

Even though IFRS 15 contract assets do not meet the IFRS 9 definition of financial assets, they are similar, and the IASB requires that impairment of IFRS 15 contract assets be performed under IFRS 9. This requirement means that IFRS 15 does not have to include its own impairment regime.

Under IPSASs, potential financial instrument-like assets include:

- assets equivalent to contract assets under IFRS 15 (IPSAS 9 – based on IAS 18)
- assets equivalent to contract assets under IFRS 15 (IPSAS 23 – where there are conditions, rather than stipulations)
- statutory receivables under IPSAS 23 such as taxes and fines, and other transfers such as statutory student loans.

It is not clear what financial instrument-like assets under IPSAS 9 and IPSAS 23 are intended to be included in the scope of ED62.

Contract assets under IFRS 15 are not financial assets under IFRS 9 because:

- they are initially measured using the allocated transaction price (not fair value)
- they are subsequently measured under IFRS 15 (which is not the amortised cost method)
- they are subject to the IFRS 15 revenue constraint
- there is no unconditional right to receive the receivable until further activity is undertaken, and the amount actually billed.

Statutory receivables will meet the criteria of a financial asset of the holder having an unconditional right to receive cash. However, statutory receivables fail the criteria of a financial asset as the right to receive arises by statute, not by contract.

When considering financial instrument-like assets, statutory receivables would appear to be closer to meeting the definition of financial asset than contract assets.

ED62 modifications to IFRS 9

ED62 proposes in paragraph 2 to exclude the following from its scope:

(j) The initial recognition and initial measurement of rights and obligations arising from non-exchange revenue transactions to which IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers) applies; except as described in AG6.

The exceptions in paragraph AG6 are:

AG6. Rights and obligations (assets and liabilities) may arise from non-exchange revenue transactions, for example, an entity may receive cash from a multi-lateral agency to perform certain activities. Where the performance of those activities is subject to conditions, an asset and a liability is recognized simultaneously. Where the asset is a financial asset, it is recognized in accordance with IPSAS 23, and initially measured in accordance with IPSAS 23 and this Standard. A liability that is initially recognized as a result of conditions imposed on the use of an asset is outside the scope of this Standard and is dealt with in IPSAS 23. After initial recognition, if circumstances indicate that recognition of a liability in accordance with IPSAS 23 is no longer appropriate, an entity considers whether a financial liability should be recognized in accordance with this Standard. Other liabilities that
may arise from non-exchange revenue transactions are recognized and measured in accordance with this Standard if they meet the definition of a financial liability in IPSAS 28.

QAO’s interpretation of the application of the exceptions to the exceptions is that:

- IPSAS 23 assets equivalent to contract assets under IFRS 15 (where there are conditions, rather than stipulations) are within the scope of ED62 – for initial recognition and measurement, and subsequent measurement, including impairment.

- Statutory receivables under IPSAS 23 such as taxes and fines, and other transfers such as statutory student loans are within the scope of ED62 – for initial recognition and measurement, and subsequent measurement, including impairment.

QAO also notes the amendments proposed by paragraph 85 to mandate the simplified impairment approach for all IPSAS 23 receivables. This (and the explanation in basis for conclusion paragraph BC 14) indicates that the above interpretation is correct.

Is the above interpretation intended by the IPSASB? QAO suggests that the IPSASB clarify its intentions, particularly as the IPSASB proposed different accounting in Consultation Paper Accounting for Revenue and Non-Exchange Expenses (e.g. Preliminary View 8 to recognise non-contractual receivables at face value (legislated amount), not fair value).

**Impairment**

It appears that paragraph 3 is intended to require ED62 to apply to impairment of IPSAS 9 and IPSAS 23 assets that are equivalent to IFRS 15 contract assets:

3. The impairment requirements of this Standard shall be applied to those rights arising from IPSAS 9 and IPSAS 23 transactions which give rise to financial instruments for the purposes of recognizing impairment gains or losses.

However, as noted above, IPSAS 9 and IPSAS 23 contract assets are not financial instruments or financial assets, because of the need for further action before the amount can be billed. Consequently, it appears that paragraph 3, which links IPSAS 9 and IPSAS 23 assets to the definition of financial instrument, is ineffective in scoping these assets into ED62.

QAO recommends that the IPSASB clarify its intentions.
Section 3 - The interaction with IPSAS 9 and IPSAS 23 – Apparent unintended consequences

The following appear to be unintended consequences of amendments to IFRS 9 for the interaction with IPSAS 9 and IPSAS 23.

Initial measurement

Paragraph 57 (IFRS 9 paragraph 5.1.1) removes the IFRS 9 exemption for recognising trade receivables at transaction price. Consistent with this removal, ED62 has removed IFRS 9 paragraph 5.1.3 on the same topic.

The IASB was very deliberate in providing an exemption for trade receivables from initial recognition at fair value. QAO understands this exemption is linked to earlier proposals (for what is now IFRS 15) to recognise the receivable inclusive of credit risk. Those proposals were subsequently rejected, for reasons including:

- the difficulty in determining the credit risk (fair value) for each debtor,
- the need to determine effective interest rates for each debtor, after adjusting for the individual credit risks
- the subsequent profit or loss movement to adjust from fair value to the amortised cost (effective interest rate) after applying the impairment model.

IFRS 15 Basis for Conclusions paragraphs BC 259 onwards has some background to the issue.

Non-Exchange Revenue Transactions

As noted above in Section 2, QAO’s interpretation is that the following are in scope of ED62:

- IPSAS 23 assets equivalent to contract assets under IFRS 15.
- Statutory receivables under IPSAS 23 such as taxes and fines, and other transfers such as statutory student loans.

QAO notes that paragraph AG114 has been added to IFRS 9 stating that initial recognition and measurement of IPSAS 23 assets is subject to IPSAS 23. These requirements appear contradictory to QAO’s interpretation of the ED62 proposals.

Impairment model for IPSAS 9 and IPSAS 23 receivables

Paragraph 85 amends IFRS 9 paragraph 5.5.15 to remove the ability of an entity to apply the “3 bucket” impairment approach to receivables within the scope of IPSAS 9 and IPSAS 23. This amendment effectively mandates the “simplified” approach of lifetime expected credit losses (ECL).

Basis for conclusions paragraph BC14 explains that this amendment was to provide relief to public sector entities. However, the consequence will be higher impairment provisions, including day 1 impairment expense.

QAO believes that public sector entities should be able to apply the “3 bucket” approach if they choose to do so. If the IFRS 9 provisions were retained (with references to IPSAS 23 instead of IFRS 15), public sector entities would have the policy choice to apply the simplified lifetime ECL approach. Consequently, as public sector entities can achieve the IPSASB’s desired outcome under the original IFRS 9 provisions, QAO recommends that the proposed amendments be removed.
Section 4 – Public sector examples

We include below suggestions on the examples and guidance included in ED62 for:

- Contingent income loans
- Reclassification of financial assets
- Concessionary loans
- Financial guarantees

We also include suggestions for additional examples and guidance to be included in ED62 for:

- Statutory student loans
- Non-recourse loans – Social or policy objectives.
- Fair value considerations for non-contract receivables
- Impairment on intra-government loans, and government to government loans

Contingent income loans

Paragraph AG63 (IFRS 9 paragraph B4.1.7A) has been modified to highlight that a contingent income loan would fail the SPPI test.

QAO suggest that the example be expanded to clarify that the consequence of this failure is that the loan will need to be accounted for at fair value through surplus / deficit.

Reclassification of financial assets

Paragraph AG111 (IFRS 9 paragraph B4.4.1) has been amended for public sector examples for reclassification of financial assets. AG111(b) includes reference to a change in business model from holding fixed income securities to collect cash flows to holding the securities for treasury management.

QAO does not believe that the example is realistic, as we would expect that holding the securities for the planned infrastructure project would be part of the treasury and trading activities of the whole of government. QAO also believes that cancellation of infrastructure projects by governments is not infrequent, and therefore such a change does not meet the “very infrequent” criteria for reclassification accounting.

Concessionary loans

Paragraphs AG118 through AG124 amend IFRS 9 by including guidance for concessionary loans. QAO suggests the examples be improved by:

- At commencement, assessing whether the loan is credit impaired
- At commencement, assessing whether the loan meets the SPPI and business model test, rather than after initial recognition (paragraph AG124 and implementation guidance paragraph G.1). This is because if the SPPI test and business model test are met, the loan would normally be recognised under IFRS 9 at fair value plus transaction costs.
- Provide additional analysis of whether the early repayment option at par (which will be higher than amortised cost of principal and accrued interest) results in the loan failing the SPPI test. This guidance could summarise an expanded implementation guidance paragraph G.2
Illustrative examples 20 and 21 (paragraphs IE153 to IE161) expand on paragraphs AG118 to AG124. QAO suggests the example be improved by:

- Changing paragraph IE154 references from department of education to international development agency, as that was the entity in paragraph IE153 that granted the loan.
- Change Scenario 2 (paragraph IE160) to remove the option for the department of education (international development agency) to be able to call the loan at any time (e.g. for say par) – QAO believes that this situation is not realistic. QAO suggests that there be an option for the student to repay the loan at any time for par. Refer our comments above on including consideration whether this would result in failing the SPPI test. If the IPSASB believes that the SPPI test would be met, the example could be reworded such that the department / agency designates the loans at fair value through surplus / deficit.
- Change paragraph IE161 to refer to the fair value through surplus / deficit and not the amortised approach.
- Change paragraph IE161 to be more realistic by having a fair value change at the end of year 1 (and Table 4).
- Identify areas to consider that have not been included in the fair value assessment, including a curve for interest rates, and possibly accounting for different years in different tranches.

The examples should clarify whether the loan is by contract, or arises through statute. In Australia, student loans arise through statute. Repayment is contingent on income above a threshold, the repayments are collected through the taxation system and the loans are non-recourse (on death the estate is not pursued for remaining debt).

Financial guarantees

Paragraphs AG128 through AG133 amend IFRS 9 by including guidance for financial guarantees issued through a non-exchange transaction. QAO suggests the example be improved by:

- Paragraph AG131 – Providing examples where there might be an active market for financial guarantees for public sector entities. In the absence of examples, QAO suggests that guidance referencing active markets be removed, and the focus be on determining a fair value.
- Paragraph AG133 – clarifying the reference to a financial guarantee existing at initial recognition. We would expect the anticipated default risk of the financial guarantee to be included in the fair value.

Illustrative example 22 (paragraphs IE162 to IE165) expand on paragraphs AG128 to AG133. QAO suggests the example be improved by:

- Paragraph IE163 – The revenue should be 1,000,000 CUs a year (not 100,000 CUs) – 5,000,000 CUs / 5 years.
- Paragraph IE165 – Narrations to be consistent with the example of 5,000,000 CUs over 5 years.
- Paragraph IE164 – Explaining the maths better:
  - After the sale to Entity D, the government is liable for the first tranche of 25,000,000 CUs and at risk for the second tranche – though at a lower risk profile – instead of a roughly 10% risk of default (original fair value of guarantee of 5,000,000 against a principal of 50,000,000), it is now roughly 2% (500,000 on final instalment of 25,000,000).
o So total liability should be 25,500,000CUs (25,000,000 default + 500,000 fair value of exposure).
  o The liability was 3,000,000 (5,000,000 amortised over 5 years after 2 years).
  o This needs to increase from 3,000,000 to 25,500,000CUs – an increase of 22,500,000CUs.

- Expand to future years to include no further changes in risk. The accounting would include the payment of the 25,000,000 default, and the amortisation of the remaining 500,000 fair value exposure over the remaining 3 years.
- The example does not seem realistic. Specifically, why would Entity D assume the liability for the loan, when the government is liable to pay the amount under a financial guarantee already in place?

**Statutory student loans**

The Australian commonwealth government student loan scheme is called the Higher Education Loan Program (HELP). As noted above, repayment is contingent on income. This alone would probably mean the loans will fail the SPPI test.

However, it would be useful if the IPASB expanded the examples to include discussion on other aspects of similar loans. This includes that the principal may not be completely repaid. In particular, if the student’s income is not sufficiently above the threshold for the loan to be repaid during their lifetime, the remaining debt on death is not recoverable from the estate.

The student loan (whether scenario 2 in paragraph IE160 or an additional example) should be expanded to consider provisions for the early repayment of the loan at a discount to par. For example a discount of 10 – 15%, and concessional interest rates of 2 – 5%. The example should also consider fair value issues, such as timing and amount of repayments.

**Non-recourse loans – Social or policy objectives.**

Examples should be included for public sector entities providing non-recourse loans for social or policy objectives. ED62 includes references to equity investments in entities such as development banks (paragraph AG125) and financial guarantees for projects (paragraphs AG130 and AG131).

An example of such a loan would be where the government provides funds to pre-commercialisation projects that have been assessed as financially viable, but need additional funds to complete bankable feasibility studies and access risk capital (in an investment decision).

Example terms could be interest-free, repayable when an investment decision is made, and if no investment decision is made within 3 years, the recipient is released from any obligations.

Considerations under ED62 / IFRS 9 would include:

- Does the non-recourse nature fail the SPPI test?
- Does the variable repayment date (when an investment decision is made) fail the SPPI test?
- If the SPPI test is passed:
  o What is the market rate of interest, when by the nature of the projects, they cannot obtain bank funding?
  o Is the loan credit-impaired on origination, when by the nature of the projects, they have significant financial difficulty (or cannot) obtain bank funding?
Fair value considerations for non-contract receivables

In QAO’s experience, public sector non-contract receivables, such as fines, will include amounts that will be uncollectible. For example, incorrect or old addresses, or not pursued (mainly for social policy reasons). QAO requests that guidance be included on these issues. For example, should the discretionary judgement by governments not to pursue debts, for social policy reasons, be included in the considerations of what a “market participant” (being another public sector entity) make? Even in the one country, some may argue that governments led by different political parties will have different social policy objectives to the extent they pursue fines. This makes it difficult to determine how these discretionary judgements should be included in the evaluation of fair value.

QAO also requests that fair value guidance be included for measuring receivables on an individual receivables or a portfolio basis. For example, the Australian commonwealth government uses the economic transaction method to value goods and services taxes (GST) and fringe benefit taxes. QAO notes that the Australian commonwealth government uses the taxation liability method for income tax, which appears to delay recognition until an assessment of a tax liability is made, or payment is received (which may be made throughout the relevant taxation year).

Guidance would also be useful in determining whether the different methods above are consistent with the fair value approach, given the difficulty in reliably measuring taxes receivable.

Impairment on intra-government loans, and government to government loans

ED62 should include practical application guidance for calculating impairment on loans and receivables held by public sector entities with government entities.

High quality government bonds are often referred to as “risk free”. This raises the question as to whether any impairment should be recognised on loans and receivables with government entities (that have issued high quality bonds).

Given that there is an historical default rate for high quality corporate bonds (even “AAA” rated), there is an argument that an impairment provision is required for such corporate loans. There have also been recent examples of defaults on government bonds initially rated as high quality (for example those of Greece prior to 2009).

Following this argument, an impairment provision would be required for intra-government loans and receivables (e.g. from treasury corporations to other government entities). However, in practice, the US government does not appear to have defaulted on its debt since the depression in the 1930’s (apart from what could be described as technical defaults in 1979 and 2013). Australia, which is AAA rated (S&P), last defaulted on its debt in 1931 (again, the depression). Even then, after adjusting for the debt restructure, investors did not suffer significant losses. As Queensland is rated AA (S&P), loans and receivables with Queensland government entities would presumably require higher impairment provisions.

Practical guidance, including the application of materiality, should be included in ED62. In particular, the theoretical approach of possible lifetime expected credit losses (and the portion for defaults in the 12-months) against the reality of an expectation of no losses. A similar issue is the application of impairment to cash and cash equivalents balances, that are technically financial assets measured at amortised cost.
Section 5 – Other matters

We highlight the following matters.

Paragraph 2(k)
This paragraph carries over the existing exclusion for IPSAS 32 Service Concession Assets: Grantor rights and obligations, except for derecognition. The exclusion appears odd, as IPSAS 32 requires the financial liability model to be accounted for under IPSAS 28, IPSAS 29 and IPSAS 30.

QAO notes that IFRIC has considered accounting for variable consideration, which may be relevant to accounting for the financial liability model.

Paragraph 9 – Definition of transaction costs (editorial)
The definition of transaction costs appears to contain an extraneous sentence (emphasis added)

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph AG160). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument. The portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

Paragraph 123(b) Hedging and investment entity
QAO found the addition of paragraph 123(b) confusing and suggests this amendment to IFRS 9 be explained in the basis for conclusions.

Paragraph AG33 – Sale of future cash flows arising from a sovereign right
ED62 includes additional guidance with AG33 relating to securitisation schemes from sovereign rights, e.g. future taxation, and royalties.

In QAO’s experience, these schemes will rarely pass the derecognition tests and criteria for revenue recognition, as the sovereign entity only has a financial asset for the immediately past year’s taxation. Consequently, the schemes will almost always be recognised as a borrowing.

QAO’s interpretation of AG33 is that the guidance does not emphasise the difficulty in meeting the relevant criteria, and could be interpreted that revenue recognition under IPSAS 9 is straightforward and likely.

Paragraph AG256(b) – Hedge example
ED62 paragraph AG256(b) amends the IFRS 9 example B6.3.10(b) from referencing Colombian coffee to Canadian wheat.

While QAO acknowledges that the IPSASB staff are based in Toronto, Canada, we do not believe the amendments provide any benefit, and suggest they be removed and the original IFRS 9 example restored.
Implementation guidance paragraph H.1

QAO suggests the following editorial changes:

Straight-line method

- The heading interest revenue be changed to interest expense, as the example is for debt
- A column be added to total interest expense and amortisation of transaction costs to arrive at a net P&L effect – which is then compared to the cash flows

Effective interest rate method

- The heading interest revenue be changed to interest expense, as the example is for debt
- The materiality assessment also consider the effect on interest expense