Comment letter on Exposure Draft 62 Financial Instruments

Dear Mr Carruthers,

We welcome the opportunity to comment on the above mentioned Exposure Draft ED 62 Financial Instruments (the 'ED'). The following comments are made in my capacity as Accounting Officer of the European Commission responsible for, amongst other tasks, the preparation of the consolidated annual accounts of the European Union which comprise more than 50 European Agencies, Institutions and other European Bodies with an annual budget of more than EUR 140 billion.

We would like to thank the International Public Sector Accounting Standard Board (the 'IPSASB') for the opportunity to contribute to the due process and we are pleased to provide you with our comments with the aim of improving the transparency, relevance and comparability of the financial statements across jurisdictions.

We generally support the IPSASB's approach to converge public sector accounting standards for financial instruments with IFRS, whenever the nature of the transaction is economically similar, and any public sector specific issue is addressed separately. Alignment with IFRS standards for financial instruments is important for the European Commission as a significant part of our budget is implemented through entrusted entities (i.e. public financial institutions) that apply IFRS. In this sense we welcome the IPSASB having based the financial instruments' project on IFRS 9 Financial Instruments, which is effective as of 1 January 2018, while adding public sector specific guidance and illustrative examples.

Overall we agree with the proposals included in the ED. Please find our detailed comments and responses to the question in the ED in the Appendix.

If you would like to discuss our comments further, please do not hesitate to contact me.

Yours sincerely,

Rosa Aldea Busquets

cc: Derek Dunphy, Martin Koehler, Bruno Gomes, Magdalena Zogala (DG.BUDG.C2)
Appendix – European Commission's response to the questions raised in the ED

Question (Specific Matter for Comment 1) – Option to continue applying previous hedging accounting requirements

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? ____________________

European Commission (EC)’s response

The EC acknowledges the complexity of hedge accounting and the reasons why the International Accounting Standards Board (IASB) has decided to separately deliberate on the accounting for macro hedging (i.e. hedging at the level that aggregates portfolios) as part of its active agenda with the objective of issuing a Discussion Paper. In the IFRS 9 Basis for Conclusions it is stated that this approach has been chosen to complete the standard more quickly and it enabled the IASB to include the new ‘general’ hedge accounting requirements as part of IFRS 9. The IASB also noted that during the project on accounting for macro hedging the status quo of ‘macro hedge accounting’ under previous standards would broadly be maintained so that entities would not be worse off in the meantime.

As a result, the standard contains a transition relief allowing entities to elect, when first applying IFRS 9, to continue applying previous requirements included in IAS 39 for hedge accounting. In order to address the risk of using hindsight, the IASB decided that on transition this election is only available on an ‘all-or-nothing’ basis (i.e. not a hedge-by-hedge basis).

The EC understands the transition relief for hedge accounting was kept in the ED due to the fact it is based on IFRS 9 (guidance is included in paragraphs ED.175 (transition relief) and ED.112 (hedge accounting chapter)).

Overall, we agree with conversion with IFRS unless there is a public sector specific issue. Nevertheless, it would be useful to understand the relevance and significance of hedge accounting, and in particular the macro hedging, in the public sector.

Currently, the EC does not designate any contract as a hedging instrument.

Question (Specific Matter for Comment 2) – Transition period for the implementation of the new standard

The IPSASB recognises 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. ____________________

EC’s response

Entities require time to understand, analyse and implement the new standard. Due to the high level of complexity of the transactions dealt with in the ED we consider the period of 3 years is a reasonable time horizon.
EC's response

The question underlines that paragraphs 153-180 of the ED provide the transition requirements in line with the requirements included in IFRS 9 for private sector entities. As referred above, convergence with IFRS is appreciated unless there is a public sector reason to diverge.

We believe in particular in the area of financial instruments that the issues faced in the private sector are generally not be significantly different from the ones in the public sector. Thus, we consider it to be appropriate to preserve the same transition requirements and reliefs as provided for in IFRS 9.

Additional comments for IPSASB's consideration:

Financial Guarantee Contract ('FGC')

Paragraph 9 of the ED defines FGCs as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of debt instrument.

Furthermore, in paragraph 45 (c), the ED specifies that, after initial recognition, an issuer subsequently measure it at the higher of: (a) the amount of the loss allowance determined in accordance with paragraphs 71-90 (impairment model requirements based on expected credit losses); or (ii) the amount initial recognised (fair value) less the cumulative amount of amortisation recognised with the principles of IPSAS 9. Moreover, additional guidance is given in paragraphs AG128-AG133 of the ED for guarantees provided at nil or no consideration, which is considered a public sector specific issue.

We appreciate that the IPSASB has carried forward the additional public sector specific guidance for financial guarantee contracts.

Notwithstanding, the EC has recently entered into new types of guarantees, such as guarantees to equity or quasi-equity instruments, which despite the fact that they are considered to be similar to FGC as defined in paragraph 9, we could not frame these guarantees in the scope of FGC as the underlying instruments were not debt instruments. The EC discussed the issue internally and concluded, by exclusion of choices, that a financial guarantee to an equity instrument should be recognised as a derivative.

Even though we are aware the IASB rejected to broaden the scope of FGC for credit derivatives (Basis for Conclusion IFRS9.BC6.518-6.521), for which guidance is also included in paragraph ED.AG5 (b) and (c) of the ED, we would like to suggest IPSASB to investigate whether guarantees to equity investments could be understood as a public sector specific issue.

The EC provides guarantees on equity investments to financial institutions in order to encourage them to increase their investing activities. Absence of sufficient investments in equity instruments, in particular for SMEs, is considered as a factor
hindering the European economy. The growth of those (often newly set-up) companies has an important positive impact on the employment but is often blocked by capital shortages. On the other hand, the institutional investors in Europe have very restrictive risk policies (sometimes also linked to legal requirements) and therefore their equity investments are limited. As such, in addition to the direct equity investments, the EU has recently entered into several contracts with financial institutions to provide guarantees to them for their additional investments in equity instruments. Under these contracts the Commission does not invest into the equity, but agrees to cover the losses financial institutions could incur in relation to their equity investments. Potential revenues from those investments are usually shared between the Commission and the financial institution.

Similarly to the guarantees provided by the Commission to financial institutions for portfolios of loans to SMEs, the reason for the Commission to enter into guarantee contracts for investments in equity instruments is to pursue its policy objectives in terms job-creation and growth of the European economy, without necessarily pursuing direct investments. Guarantee agreements lead to higher leverage effects as the losses from the guaranteed portfolios are limited and therefore less budget is needed to achieve desired effect.

In conclusion, we would suggest discussing and investigating whether financial guarantees given to cover equity investments could be seen as a public sector specific issue, and if so, whether the guidance on FGC in IPSAS could be expanded to include guarantees to equity investments.

Prepayment features with negative compensation

The IASB\(^1\) has recently amended IFRS 9 by introducing guidance on the classification of a financial asset that contains a contractual term that could change the timing and amount of contractual cash flows.

The amendment clarifies that a financial asset that would otherwise meet the SPPI condition in IFRS 9 but does not do so only as a result of a contractual term that permits (or requires) the issuer to prepay a debt instrument or permits (or requires) the holder to put a debt instrument back to the issuer before maturity, is eligible to be measured at amortised cost or fair value through other comprehensive income (subject to meeting the business model condition) in certain conditions.

The EC is of the view that this guidance might be useful for the public sector as the features described in IASB’s document are likely to occur as well in the public sector.

In this context, we consider that it would not be appropriate to classify this contract as fair value through surplus or deficit. Therefore, we suggest the IPSASB to investigate, discuss and perhaps include the guidance provided amendment in IFRS 9.

Equity Instruments – Impairment and recycling

According to the requirements set out in paragraph 103 of the ED, at initial recognition, an entity may make an irrevocable election to include in net assets/equity, subsequent changes in the fair value of an investment in an equity instrument that is neither held for trading nor contingent consideration recognised by an acquirer in a public sector combination.

\(^1\) ED/2017/3 Prepayment Features with Negative Compensation
For equity instruments for which subsequent changes in fair value are presented in net assets/equity, the amounts recognised in net assets/equity are never reclassified to surplus or deficit (ED 62.AG219).

The EC understands the prohibition to reclassify the amounts recognised in net assets/equity to surplus or deficit is a requirement that comes from IFRS 9, on which the ED is based. During the IASB’s consultation process, some constituents responded to the IASB that they did not support the proposal to prohibit subsequent transfer (‘recycling’) of fair value changes to profit or loss (on derecognition of the investments in an equity instrument), nevertheless, the IASB concluded that: (i) a gain or loss on those investments should be recognised once only; therefore, recognising a gain or loss in Other Comprehensive Income and subsequently transferring it to profit or loss was inappropriate; and (ii) recycling would create something similar to the Available-for-sale category in IAS 39 Financial Instruments and would create the requirement to assess the equity instruments for impairment.

Accordingly, the IASB decided to prohibit recycling of gains and losses into profit or loss when an equity instrument is derecognised.

The discussions held within Europe on this subject, namely, at European Financial Reporting Advisory Group (EFRAG) – which is the entity providing advice to the European Commission on whether newly issued or revised IFRS meet the criteria in the EU Regulation for endorsement process within the EU – showed that there are concerns concerning this decision. As a consequence, the EC has requested EFRAG to deliver a technical advice on this subject, for which the work is currently ongoing.

We believe that the same concern is valid for the public sector, thus, we suggest IPSASB to further analyse the accounting treatment for equity investments classified as fair value through net assets/equity. In particular, in our context the statement of financial performance is perceived as a reflection of the budget execution in accounting (accrual) terms. As the financial instruments, including the equity investments, are one of the methods of budget execution (provision of financial support), the costs incurred in relation to those investments would be expected to be recognised in the statement of financial performance. Consequently, by not allowing for recycling to the statement of financial performance for this category a complete performance analysis would not be possible.

This particularly important since the IPSASB has decided not to introduce a statement of other comprehensive income as it exist under IFRSs and therefore the sole statement which would reflect the performance is the statement of financial performance. By not allowing recycling, IPSASB is strengthening the notion of 'other comprehensive income'.

**Dividends or similar distributions**

Currently, dividends or similar distributions are in the scope of IPSAS 9 Revenue from Exchange Transactions (IPSAS 9.1), which further explains in paragraph 9 that dividends or similar distributions are considered "distributions of surplus to holders of equity investments in proportion to their holding of a particular class of capital". Furthermore, paragraphs 33-34 of IPSAS 9 set out the criteria for recognition, essentially, dividends are recognised when:

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(i) It is probable that the economic benefits or service potential associated with 
the transaction will flow to the entity;
(ii) The amount of the revenue can be measured reliably; and
(iii) Dividends shall be recognised when the shareholder's or the entity's right to 
receive payment is established.

The ED (in paragraph 9) also defines dividends and similar distributions as 
"distributions to holders of equity instruments in proportion to their holdings of a 
particular class of capital". Similarly to IPSAS 9, paragraph 99 of the ED provides the 
criteria for the recognition as follows:

(i) The entity's right to receive payment of the dividend is established;
(ii) It is probable that the economic benefits associated with the dividend will flow 
to the entity; and
(iii) The amount of the dividend can be measured reliably.

In our view, although the requirements are not contrary in both standards, we 
consider the requirements for recognition; measurement and presentation of 
dividends arising from financial instruments should be excluded from the scope of 
IPSAS 9, similarly to the scope exclusion for investments accounted in accordance 
with IPSAS 36 Investments in Associates and Joint Ventures that already exist. From 
a preparer's point of view, it is not clear which standard should be applied.

Therefore, we suggest IPSASB to scope out the recognition of dividends arising from 
financial instruments (i.e. in the scope of the ED) from IPSAS 9. Alternatively, the 
requirements for recognition of dividends could be eliminated from IPSAS 9, as we 
do not see other investments outside of the scope of IPSAS 36 (equity method) or 
the ED that would generate dividends.

Sovereign rights

The EC acknowledges the relevance of sovereign rights in the public sector context 
and we agree that additional guidance was needed.

Although, we consider the paragraph AG33 is difficult to understand and should be 
clarified to avoid misunderstandings and diversity in the application of the guidance 
provided. In particular, it is not explicit what is intended to capture with the term 
sovereign right and what is the accounting treatment proposed.

Therefore, to avoid application issues, we would propose that the definition of 
sovereign rights is included in the ED, in addition to the example provided ('such as 
taxation').

Regarding the accounting treatment, we note that under normal circumstances 
revenue arising from taxation would be accounted for in accordance with IPSAS 23 
Revenue from Non-Exchange Transaction (Taxes and Transfers), however, the ED 
refers that consideration received on selling a sovereign right – for example taxation 
– would be accounted for IPSAS 9. In our view, it is not clear in the guidance 
whether an asset would arise as a consequence of the sell and whether the revenue 
is recognised twice: first, as a result of the sale of the sovereign right (exchange 
transaction) and secondly, as a result of the taxable event (non-exchange 
transaction). Furthermore, the paragraph is not very clear on the fact that the asset 
can only be recognised when the right is sold. Finally, the link with the liability is also 
not evident in case the revenue has been already recognised.

Given the above, we would like to propose to the IPSASB to (i) define sovereign 
right; (ii) clarify the accounting treatment of the sale of a sovereign right; and (iii)
clarify the case of the liability, preferably by providing an illustrative example as regards to this additional guidance.

Classification of financial assets

The ED includes guidance on how to evaluate the entity's management model for financial assets in paragraphs AG.48-51 of the ED.

The guidance is extremely useful for preparers, so as to ensure the correct classification of financial assets, by clarifying that the management model does not depend of the managements' intentions for an individual asset but how the portfolio is managed. Notwithstanding that, the changes to the IFRS 9 made in ED 62, i.e. replacing the word "intentions" by "management model", in our view, turned the paragraph unclear and might have changed the intended meaning.

The paragraph (with track-changes) is as follows:

"An entity's business management model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The entity's business management model does not depend on management's intentions management models for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation. (...)"

We believe the original wording should be kept so that the paragraph could be easily understandable by the preparers in applying the guidance that is being provided.

Guidance on measurement

According to the ED (paragraph 57) at initial recognition, an entity shall measure a financial asset or a financial liability at its fair value. Furthermore, the ED provides additional guidance in paragraph AG.117 on measuring a financial asset or financial liability when at initial recognition the fair value differs from the transaction price.

However, we noted that the guidance on measuring on initial recognition was kept by the IPSASB (in paragraph AG.117); the paragraph was deleted in the body of the ED (we refer to paragraph 5.1.1A of IFRS 9).

Likewise, on subsequent measurement, the cross-reference for the guidance provided in paragraph AG.117 was deleted (we refer to paragraph B5.2.2A of IFRS 9).

We would thus suggest re-introducing both paragraphs as they are useful to draw the attention of preparers that further guidance is available and must be used on measuring the fair value of financial assets and financial liabilities.

Short-term receivables

The IASB included in IFRS 9 a practical expedient (IFRS 9.5.1.3) for short-term trade receivables where an entity shall, at initial recognition, measure trade receivables at their transaction price if the trade receivable does not contain a significant financing component. Furthermore, it is explained in the Basis for
Conclusion of IFRS 15, that this practical relief is applicable for contracts with an expected duration of one year or less.

In our view, the interest is required to be imputed when the impact of discounting would be significant and an entity is permitted to measure short-term receivables and payables with no stated interest rate at their invoiced amounts without discounting, if the effect of discounting is immaterial. IPSAS 3 Accounting Policies, Changes in Accounting Estimates and Errors in paragraph 10, already set out that an accounting policy needs not to be applied when the effect of applying them is immaterial.

Thus, we understand that IPSASB decided to remove this guidance from the ED in order to discuss it in the revenue project which is ongoing. While we agree that the issue should be dealt with within the revenue standard, we note that this is a useful relief and there is no public sector specific reason to not include it in IPSAS. Consequently, we believe that this relief should be ultimately provided.

Minor comments regarding drafting of the ED:

- Paragraph ED.10: We would like to draw the attention to paragraph 10 of the ED, in which one reference must be update. The paragraph is as such: "(...) in accordance with paragraphs 57 and 0 (...)", we believe it should be "(...) in accordance with paragraphs 57 and 0 58 (...)."

- Paragraph ED.AG120: This paragraph makes reference to the derecognition requirements of the ED, in our view it should be cross-referenced directly to the related paragraphs (ED.12-34).

- Illustrative Example n. 31: Footnote includes reference to IPSAS 30 Financial Instruments: Disclosures, however, we believe it was intended to refer to IPSAS 28 Financial Instruments: Presentation.