



Accounting Standards Board

P O Box 7001
Halfway House
1685
Tel. 011 697 0660
Fax. 011 697 0666

The Technical Director
International Public Sector Accounting Standards Board
277 Wellington St W
Toronto, ON M5V 3H2
Canada
19 December 2017

Per electronic submission

Dear John

COMMENTS ON EXPOSURE DRAFT 62 ON *FINANCIAL INSTRUMENTS*

We welcome the opportunity to comment on ED 62 which outlines proposed revisions to IPSAS 28, 29 and 30 on financial instruments. This letter outlines the views of the Secretariat of the Accounting Standards Board. These views were developed after consultation with preparers, auditors and other interested parties.

In principle support for change, but timing and linkages to other projects need consideration

While we believe that it is appropriate to align the existing IPSASs with the latest versions of the IFRSs, the IPSASB should not underestimate the complexity of implementing these Standards. A key challenge will be implementing the change from the incurred to the expected credit loss model. We are firmly of the view that practice should be allowed to develop sufficiently in the private sector before implementing these changes in the public sector. As a result, the proposed implementation date should be reconsidered.

We also urge the IPSASB to consider the linkages between this project and work on developing an equivalent of IFRS 15 *Contracts with Customers* and IFRS 16 *Leases*. The linkages between IFRS 9 *Financial Instruments* and IFRS 15 and IFRS 16 are integral and ensure that revenue and related receivables are recognised and measured in a coherent way. We have outlined areas in the specific matters for comment and Part B of our letter that we believe should be considered.

Board Members: Ms T Coetzer (Chair), Mr B Colyvas, Ms I Lubbe, Mr M Kunene, Mr K Makwetu,
Ms Z Mxunyelwa, Mr V Ndzimande, Ms N Ranchod, Ms R Rasikhinya, Ms C Wurayayi
Alternates: Ms L Bodewig, Ms M Sedikela
Chief Executive Officer: Ms E Swart, Technical Director: Ms J Poggiolini



Specific issues identified

Part A of our letter outlines our responses to the specific matters for comment included in the Invitation to Comment.

We identified a number of other issues which are outlined in Part B.

Should you require any clarity on any of the issues raised in our letter, please feel free to contact me directly.

Yours sincerely

A handwritten signature in black ink, appearing to read "Poggiolini". The signature is written in a cursive, flowing style with some loops and flourishes.

Jeanine Poggiolini

Technical Director

PART A – RESPONSES TO SPECIFIC MATTERS FOR COMMENT

Specific matter for comment 1

We agree that entities should be allowed to apply the hedging requirements in IPSAS 29 *Financial Instruments* or those in ED 62 for the following reasons:

- The IASB's work on hedging is not yet complete, and as a result, amendments are likely to be made to both IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9.
- As for-profit entities that apply IFRS are permitted to apply the requirements in IAS 39 or IFRS 9, it is important to consider how this affects mixed group consolidations in the public sector. For example, if government business enterprises that apply IFRS can choose the hedging requirements in either IAS 39 or IFRS 9, it is appropriate that public sector entities have the same choices otherwise accounting policy differences may arise on consolidation.

Specific matter for comment 2

While we support having a longer period between approving the Standard and it becoming effective, we are unconvinced that the three year time period proposed is appropriate. We believe that the IPSASB should consider what an appropriate time period is based on the following factors:

- IFRS 9 is effective for private sector entities from 1 January 2018. The IPSASB's current timeframe for issuing ED 62 as a final IPSAS is September 2018. This means that the private sector will have been through approximately two reporting cycles before public sector entities would be required to apply the revised IPSAS. We are concerned that practice would not have developed sufficiently in the private sector which means that implementation in the public sector may be challenging.
- We believe that there is an integral link between IFRS 9 and IFRS 15. These two standards interact to ensure that the accounting for revenue and the resulting receivables are consistent. This is particularly important when considering the recognition of revenue and receivables that are credit impaired on origination, as well as considering whether a transaction includes a material/significant financing component. If the equivalent of IFRS 9 is issued without IFRS 15 in place, there is likely to be a significant amount of change required by entities (to both revenue and receivables) once an equivalent of IFRS 15 is issued. We believe that the IPSASB should consider not making the revised IPSAS on financial instruments effective until the equivalent of IFRS 15 has been issued.
- As with IFRS 15, we are concerned about potential changes that may be proposed by the IASB to IFRS 9 just as the revised IPSAS is being implemented.

Specific matter for comment 3

We support the proposed transitional provisions. If the guidance on equity instruments issued in non-exchange transactions is retained, specific transitional provisions may be needed for these arrangements. For example, if the requirements of ED 62 need to be applied to these arrangements retrospectively, then guidance may be needed on when or how the non-exchange element is assessed and measured.

PART B - OTHER MATTERS

Area	Comment
Scope	<p>AG6 indicates that when recognising a financial asset that arises from a non-contractual arrangement in IPSAS 23 <i>Revenue from Non-exchange Transactions (Taxes and Transfers)</i>, the requirements of ED 62 and IPSAS 23 are applied for initial measurement. There is no equivalent guidance in IPSAS 23. It may be useful to amend paragraph 43 of IPSAS 23 to direct readers to ED 62.</p>
Classification	<p>The interaction between the section on concessionary loans (under <i>Initial Measurement</i>) and the classification of such instruments is unclear. While examples of contingent repayment features typically present in concessionary loans have been added in paragraph AG63, it is not immediately clear that some concessionary loans may in fact fail the solely payments of principal and interest test. It may be useful to include such an example in the application guidance explaining the classification of instruments.</p>
Initial measurement	<p><i>Recognition of gains and losses on initial recognition</i></p> <p>Paragraph AG117 outlines the requirements for how any difference between the transaction price and fair value on the initial recognition of a financial instrument should be treated. This paragraph should indicate that it does not apply to concessionary loans as separate guidance is provided in AG123.</p> <p><i>Financial guarantee contracts</i></p> <p>Paragraph AG133 indicates that, if a reliable measure of fair value is not available for a financial guarantee contract issued in a non-exchange transaction, the principles in IPSAS 19 <i>Provisions, Contingent Liabilities and Contingent Assets</i> are applied.</p> <p>While we are of the view that guidance is needed when a reliable measure of fair value is not available, we do not believe applying IPSAS 19 is appropriate. This may have been appropriate under IPSAS 29 as the subsequent measurement of financial guarantees was the higher of fair value and the amount determined in IPSAS 19. However, the subsequent measurement of financial guarantee contracts has changed. These contracts are now measured at the higher of fair value and the loss allowance.</p> <p>As a result, we suggest that if a reliable measure of fair value is not available, then an entity should determine the loss allowance on initial recognition. We believe that without such a change, the initial measurement and subsequent measurement approaches outlined in ED 62 for financial guarantee contracts issued in non-exchange transactions are incompatible.</p>

Should the initial measurement be changed as suggested, the IPSASB should consider whether any specific transitional provisions are needed.

We also note that paragraph AG5(a) needs to be updated to indicate that not all financial guarantee contracts are measured initially at fair value.

Equity instruments issued in non-exchange transactions

Paragraphs AG125 – 127 refer. The title “equity instruments issued in non-exchange transactions” does not appropriately convey the meaning of the underlying transaction. We suggest rewording it to “concessionary investments”.

Concerns were expressed by preparers about the use of the term “in substance” in paragraph AG126. It is significantly difficult in practice to identify when a transaction is an equity transaction given the lack of clarity about what “equity” represents in the public sector. Given that the types of investments in question are often in start-up entities, it is often difficult to quantify the value of the equity acquired as the entity has no value at that point in time. The equity contribution is often based on capital needed to ensure that the entity is able to successfully commence its operations.

As a result, we believe the terms of the arrangement would need to expressly indicate whether the transaction represents the acquisition of an equity interest, and/or another component. We note that in paragraph 38 of IPSAS 23, contributions from owners are evidenced by specific arrangements or designations, and we see no reason why the same principle should not apply in ED 62.

We also note that there is no text proposed in IPSAS 23 to indicate the interaction between the principles in IPSAS 23 and ED 62. There are also no specific disclosure requirements that have been proposed.

Transactions with material/significant financing components

We note that there is no specific guidance on how to deal with financing components in transactions that give rise to receivables and payables.

In IFRS 15 (which should be read with IFRS 9), a practical expedient has been introduced which indicates that if an entity expects collection of the consideration in a revenue transaction within 12 months, then the entity can ignore the effect of discounting (for the recognition of revenue and the receivable). While the discounting of transactions with a maturity of less than 12 months may be considered immaterial/insignificant in some parts of the world, where interest rates are high this is a complex issue. For example, in South Africa where the interest rate is approximately 10%, any debts outstanding for longer than 30 days can have a material effect on how revenue is classified.

For this reason, we believe it may be appropriate to indicate that an entity need not discount receivables arising from revenue transactions where consideration will be received within 12 months. This will also go some

	way to aligning IFRS 9 with the requirements of IFRS 15.
Subsequent measurement	<p><i>Assessing whether a financial asset is credit impaired</i></p> <p>The definition of a credit impaired financial asset includes events such as “the significant financial difficulty of the issuer”, “granted to the borrower a concession that the lender would otherwise not consider”, “the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses”.</p> <p>It is unclear from ED 62 whether an entity should consider whether concessionary loans are credit impaired on initial recognition. Some of the events listed in the definition would often be the reasons for granting a concessionary loan.</p> <p>ED 62 should make the following clear:</p> <ul style="list-style-type: none"> (a) Should an entity assess whether concessionary loans are credit impaired, and if yes, when should this assessment be made. (b) If concessionary loans should be assessed for credit impairment, it would need to be clear that some of the events listed in the definition may not apply to concessionary loans as this would lead an entity to automatically conclude that a concessionary loan is credit impaired, when in fact those characteristics may have been considered in the initial measurement of the loan. (c) Guidance is needed on the difference between credit losses and changes in the value of the cash flows of the asset due to the concessionary terms of the loan.
	<p><i>Purchased or originated credit impaired instruments</i></p> <p>In discussing the concept of purchased or originated credit impaired financial assets with preparers, two key issues were raised in relation to receivables and revenue transactions:</p> <ul style="list-style-type: none"> (a) Whether recognising the receivable based on the expected cash flows (including expected credit losses) affects the amount of revenue recognised. (b) The practical difficulties in measuring interest revenue. <p><u>Revenue recognition</u></p> <p>If an entity enters into a transaction to provide goods or services in a sale transaction (or a revenue transaction that is in the scope of IPSAS 23), questions were raised about the amount of revenue to be recognised. Because ED 62 requires that the receivable should be recognised using the expected cash flows (which include credit losses), it is assumed that revenue equal to the receivable will be recognised. While this approach is broadly consistent with the principle in IPSAS 9 <i>Revenue from Exchange Transactions</i> and IPSAS 23 of recognising revenue based on probability, we have concerns about the potential implications should the IPSASB adopt IFRS 15.</p>

IFRS 15 requires the recognition of revenue in full, unless the transaction includes significant credit risk. Where this is the case, the transaction is not considered a revenue transaction (See BC265 of IFRS 15). In these situations, an entity recognises any consideration received on a cash basis. Or alternatively if the receivable is recognised, then the “credit” is a deferral in accordance with IFRS 9.

In the South African context, municipalities and utilities are required to provide services to third parties regardless of their credit risk. This means that there are significant portfolios of receivables that are credit impaired on origination. While funding may be received from another level of government to compensate the municipalities for such transactions, that is a separate transaction which should be accounted for in accordance with IPSAS 23.

If the outcome of applying ED 62 and any future IPSAS based on IFRS 15 is that there is no revenue transaction and any consideration received is accounted for on a cash basis (or as a deferral) does not ensure that entities are held accountable for their activities.

We urge the IPSASB to consider this issue when it considers IFRS 15 as it has significant consequences for holding entities accountable in the public sector.

We also note that, depending on the outcome of the IPSASB’s proposed lessor accounting model, this issue may also arise for lease revenue.

Practicalities of recognising interest revenue

ED 62 requires an entity to recognise interest revenue based on originated credit impaired instruments using the amortised cost of the instrument and the credit adjusted effective interest rate.

Similarly, if a financial asset becomes credit impaired, the amortised cost and the effective interest rate is used to determine revenue.

The implications of these requirements are as follows for receivables for the sale of goods and services:

- An entity’s debtors’ ledger would calculate interest on the nominal/contractual interest rate.
- When an entity calculates interest for financial reporting purposes, it would need to use a different basis (net rather gross basis) and interest rate (credit adjusted effective interest rate, or effective interest rate). Note: We are aware that the effective interest rate and the nominal/contractual rate may not be significantly different, but the credit adjusted effective interest rate will be different.
- Most entities indicated that these calculations will need to be done outside of their general ledger systems, which mean that there is likely to be a significant amount of “manual” intervention required in determining these amounts. [This includes entities who use large ERP

	<p>systems] This will require more resources, and will likely affect the potential risk of misstatement in the financial statements.</p> <p>We do not believe that this level of complexity is needed for basic instruments such as receivables for sales of goods and services and urge the IPSASB to reconsider this approach for receivables.</p> <p><i>Expected credit loss impairment model</i></p> <p>While there was support for the expected credit loss model, preparers indicated that additional examples are needed illustrating the basic principles of the approach. For example, an illustration of how probabilities should be assessed, how modification gains and losses should be determined (and how this affects the effective interest rate).</p> <p><i>Equity instruments and the use of cost for subsequent measurement</i></p> <p>It was observed that all equity instruments need to be measured at fair value subsequently. We noted from paragraph AG136 that cost may be used in limited instances, and only where there is no better recent information. Paragraph AG137 includes a number of indicators when using cost may be inappropriate. We believe that these indicators are overly restrictive and will not result in entities being able to use cost.</p> <p>Entities in the public sector frequently acquire equity interests in unlisted entities. It is difficult and onerous to obtain valuations for these investments and we do not believe that restricting the use of cost as outlined in AG137 is in the best interest of the public sector which has scarce resources. The deletion of AG137 may go some way to relaxing the requirements for the use of cost.</p>
<p>Public sector amendments needed</p>	<p><i>Public sector application of certain principles</i></p> <p>In reviewing the text of ED 62, we noted instances where the text and/or examples need to be modified to be public sector specific. These include:</p> <p>Paragraph 170 – refers to interim periods. As there is no IPSAS on interim reporting, we suggest deleting this paragraph.</p> <p>AG112 – refers to a financial services firm in the example. This should be modified as there are no (or very few) such entities that will apply IPSAS.</p> <p>AG164 – refers to retail loans. These are not likely to be common in the public sector.</p> <p>AG178(n) – refers to credit card borrowers. These transactions are not likely to exist in the public sector.</p> <p>AG230 – refers to a mortgage bank. This type of entity is unlikely to apply IPSAS.</p>
<p>Disclosures</p>	<p><i>Paragraph 37 and 37A</i></p> <p>For the reconciliation between the opening and closing nominal values to make sense, we suggest renumbering (b) to (vii) so that it indicates that this is end result of the reconciliation.</p>

Implementation guidance	Given the complexity of ED 62, we recommend that the IPSASB compile educational material to assist entities with a basic understanding of financial instruments and the requirements of ED 62. While there is existing implementation guidance and illustrative examples, these are often complex and assume readers have a sound understanding of financial instruments when this is, in most cases, not an appropriate assumption.
--------------------------------	--