THE TREASURY
Kaitohutohu Kaupapa Rawa

# Guidance on Accounting for Financial Instruments Under PBE IFRS 9 for Non-financial Entities

## Practical Guide for entities restricted from investing and borrowing activity

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New Zealand Government

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# Purpose and Overview

On 12 January 2017 the New Zealand Accounting Standards Board of the External Reporting Board issued PBE IFRS 9 *Financial Instruments*. This accounting standard updates the principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.

The Crown has resolved to adopt PBE IFRS 9 *Financial Instruments* for financial statements prepared for periods beginning on or after 1 January 2018. Accounting for financial instruments, especially those with complex features, can be difficult. Among other things the standard deals with the classification of financial assets and financial liabilities, which can impact how they are measured in the accounts, impairment and hedge accounting items.

Under the Public Finance Act 1989 and the Crown Entities Act 2001, all government departments and Crown entities subject to s.161-164 are restricted from investing and borrowing activity. The application of PBE IFRS 9 to these entities is therefore likely to be limited to accounting for:

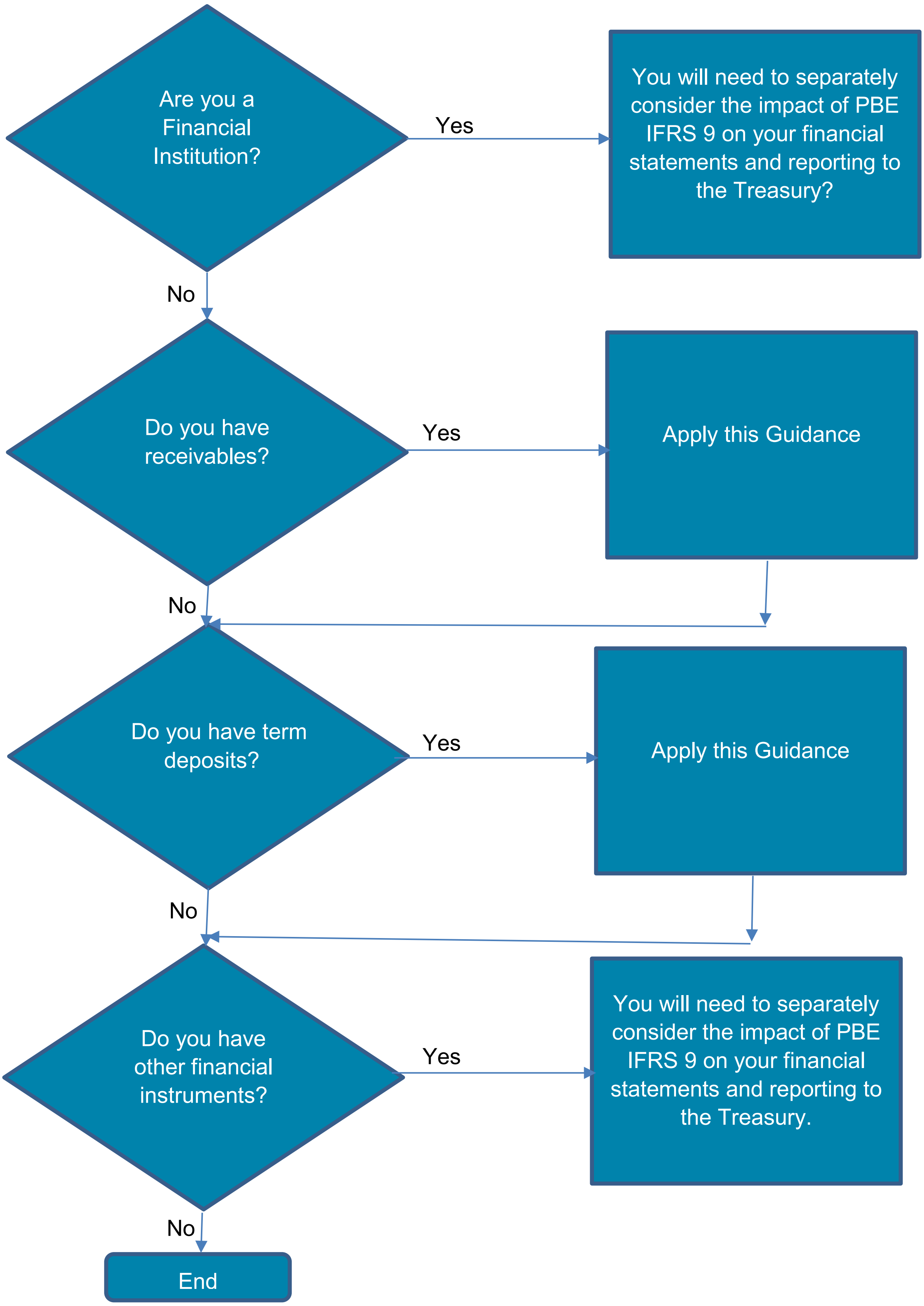
- Debtors or receivables (including provisioning)
- Term Deposits issued by a registered bank, or by any other entity that satisfies a credit-rating test that is specified in the Crown Entities (Financial Powers) Regulations 2005.

In practice, the major impact is likely to be over the more detailed requirements for impairments of accounts receivable (provisioning for doubtful debts).

This guidance note has been prepared to provide practical and simple assistance for such entities to adopt and subsequently assert compliance with the requirements of PBE IFRS 9 *Financial Instruments.* It has been organised to provide advice on accounting for both of the issues above.

Treasury has consulted with the Audit Office in the preparation of this document.

# Use of This Guidance



# About This Guidance

This guidance document sets out practical application guidance to departments and certain Crown Entities in preparing their annual reports in accordance with the Public Finance Act 1989 and in submitting information to the Treasury for the purpose of whole-of-Government reporting to facilitate compliance with PBE IFRS 9 *Financial Instruments*.

This guidance document should be read by Chief Financial Officers, Financial Controllers and other finance staff with responsibility for preparing annual financial statements, financial forecasts and the provision of financial information to the Treasury.

The guidance outlined in this document applies to financial statements and forecasts prepared for periods beginning on or after 1 January 2018. It applies until this document is updated or replaced.

This document has been written by the Fiscal Reporting Team at the Treasury with assistance from the Audit Office.

## Questions and feedback

You should use this document as your first point of call for accounting issues in reporting on financial instruments.

General enquiries about the information contained in this guidance, not addressed in this guidance or the associated FAQs, can be directed to fiscalreporting@treasury.govt.nz.

Any agency-specific questions should be addressed to your Treasury Vote team.

Any comments as to how we could improve this guidance can be directed to guidance@treasury.govt.nz.

## Further information

This document provides application guidance in support of PBE IFRS 9 *Financial Instruments*. That standard itself can be directly accessed at http://www.xrb.govt.nz/accounting-standards/public-sector/pbe-ifrs-9/.

Other useful information can be found at:

- Audit NZ's Model Financial Statements under the new PBE accounting standards
- Deloitte's summary, analysis, and history of IFRS 9
- EY's Applying IFRS: IFRS 9 for Non-Financial Entities
- KPMG's Financial Instruments for Corporates – Are you good to go?
- PWC's IFRS 9 Publications

# 1 Accounting for Receivables (Debtors)

| | |
|---|---|
| **New requirement:** | PBE IFRS 9 changes the rules for loss allowances (provision for doubtful debts) |

## 1.1 What this section applies to

Departments and Crown entities covered by this guidance do not have the primary business of providing loans or borrowing. Rather, they deliver public services.

These entities may however have significant receivables from trading activity in their financial statements. Such receivables do meet the definition of a financial instrument and as a result, they are subject to PBE IFRS 9.

This guidance apples to such receivables, but not to any receivables that contain a significant financing component (in which case they would likely be in breach of Treasury Instruction 6.3.6 Prohibition on investing, borrowing or lending). It applies to trade receivables (the receivable arises from contracts with customers or citizens) and lease receivables.

This guidance does not apply to sovereign receivables (i.e. receivables arising from the exercise of sovereign power such as taxes or levies) as their initial recognition and measurement continues be in the scope of PBE IPSAS 23 *Revenue from Non-Exchange Transactions* and they do not meet the definition of a financial instrument.

This guidance also does not apply to loan and advance schemes, in particular those that are provided on concessionary terms. The accounting policies for such schemes need to be individually assessed, which is beyond the scope of this generalised guidance.

The words receivables and debtors have the same meaning in this guidance.

## 1.2 When should a receivable be recognised?

Recognition rules are set in revenue and lease standards. Recognition rules have not changed as a result of PBE IFRS 9.[1]

## 1.3 What is the initial value of the receivable?

Usually, a receivable should initially be recognised at its transaction price, so long as this amount is able to be received.

An example of a transaction price is the price on an invoice or the fee for a permit or a licence. In most cases the transaction price is the best indicator of fair value and should be the initial value of the receivable.

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[1] The two main revenue standards are PBE IPSAS 9 *Revenue from Exchange Transactions* and PBE IPSAS 23 *Revenue from Non-Exchange Transactions. The Lease standard is PBE IPSAS 13.*

## 1.4 What allowance for losses (doubtful debt provision) should be made?

PBE IFRS 9 moves from an incurred loss model to an expected loss model the impairment of financial instruments including trade receivables. It permits the use of a simplified approach for impairing receivables. This simplified approach involves making a provision (loss allowance) at an amount equal to lifetime expected credit losses.

Departments and Crown entities should follow this simplified approach. For information, the more complex general model is described in the appendix to this guidance.

There are six steps to calculating the lifetime expected credit losses.

1. Calculate historical loss rates, for different aged receivables.
2. Assess the results for concentrations where history shows there are different loss patterns (e.g. geography, type of customer) in the portfolio.
3. Assess whether external information suggests that historical loss changes for these groups or concentrations are likely to be affected.
4. Make adjustments to historic loss rates to affect this assessment.
5. Apply adjusted historic loss rates to current receivables.
6. Document the above process.

For Financial Statement of Government reporting purposes, the following ages will be used and Treasury therefore recommends they also be used by Departments and Crown entities for efficiency:

- Current
- Less than six months past due
- Between six months and one year past due
- Between one and two years past due
- Greater than two years past due

In many cases there will not be separate concentrations where history shows there are different loss patterns. Even where there are such concentrations, adjustments are only required if external information suggests that the historical loss rates are no longer appropriate. An example might be if a large earthquake has impacted a metro area where there is a significant concentration of risk. Departments and Crown entities are however encouraged to include in their working papers, evidence that they have considered this possibility.

The process of updating the allowance should be completed for each year's audited financial statements for all departments and for all Crown entities. For the purpose of reporting through CFISnet to the Treasury, the process should be also be completed for each forecast update if the entity has receivables more than $500 million.

The following example shows how the simplified approach in PBE IFRS 9 works and is different from the previous PBE IPSAS 29.

**Example: Allowance for losses (doubtful debt provision)**

ABC, a government department, has receivables from customers with gross carrying amount of $500,000 at the end of 2018. Careful analysis of these receivables has shown the following:

- One of ABC's customers, debtor A, filed for bankruptcy during 2018. The receivable from debtor A was $2,200 but the expected recovery is now close to nil.
- There are no groupings of receivables with significantly different loss patterns.
- The aging structure and experience of the remaining receivables is as follows:

| Past due days | Amount $ | Estimates of losses | Impaired credit loss $ | Expected credit loss $ |
|---|---|---|---|---|
| Current | 392,200 | 0.5% | | 1,961.00 |
| < 6 months | 79,900 | 2.5% | | 1,997.50 |
| 6 months -1 year | 13,200 | 8.9% | | 1,174.80 |
| 1 - 2 years | 7,500 | 20.3% | | 1,522.50 |
| > 2 years | 5,000 | 70.0% | | 3,500.00 |
| Debtor A | 2,200 | 100.0% | 2,200 | |
| **Total** | **500,000** | | **2,200** | **10,155.80** |
| | | | | |

The middle column of the table contains percentages of expected credit loss in the individual aging groups. ABC estimated these percentages based on the historical experience and adjusted it, where necessary, for forward-looking estimates.

PBE IAS 39 requires recognising the impairment loss ***to the extent it has already been incurred***. This means not looking to future expectations but rather an examination of just the events leading to impairment losses already incurred.  In ABC's receivables portfolio, there's ***only one*** such receivable with incurred impairment loss. As ABC assumes the recovery close to nil, under PBE IPSAS 29, it recognises bad debt provision amounting to 100% of the receivable's gross carrying amount of $2,200.

Under PBE IFRS 9, the bad debt provision to debtor A's receivable of $2,200 will not be any different. This receivable has already been credit impaired and full lifetime expected credit loss is simply 100% of this receivable – $2,200. However, for the remaining receivables, based on the statistics in the 3rd column, ABC can reasonably expect some credit loss, although no loss events have happened yet. As a result, ABC will need to recognise a bad and doubtful debt provision, per the simplification permitted by PBE IFRS 9, of $12,355.80.

## 1.5 What is the appropriation treatment? (Departments)

Movements in allowances for losses should be treated as an expense in their financial statements by departments.  Departments are referred to "Measuring Remeasurements" for guidance as to whether this expense requires appropriation or may be treated as a remeasurement.

## 1.6 What is the accounting policy disclosure?

A suitable accounting policy disclosure would be:

"Receivables are reported at their face value, less an allowance for expected losses."

# 2 Accounting for Term Deposits

**New requirement:** PBE IFRS 9 introduces a new model for classifying financial assets.

## 2.1 What this section applies to

Crown entities may hold term deposits and other financial assets for liquidity management purposes. Durations are usually set in accordance with expected cash flow needs.

Crown entities authority to hold such assets is established under the s.161 of the Crown Entities Act 2004 and the Crown Entities (Financial Powers) Regulations 2005. In summary, these generally restrict Crown entities' acquisition of financial assets to a debt security denominated in New Zealand dollars that satisfies

a) Standard & Poor's Rating "A−" or higher or, if short term, "A−1" or higher; or

b) Moody's Rating "A3" or higher or, if short-term, "Prime−1" or higher.

## 2.2 Accounting for term deposits

In setting out the accounting requirements for financial assets such as term deposits, PBE IFRS 9 requires a number of assessments and judgements.

Generally however, term deposits can be reported at the amount invested. Unpaid interest on these investments will be accrued and added to the investment balance as is the current practice. The following traces the logic of applying the standard to get to this result:

- Accounting on an amortised cost basis is allowed if term deposits are held within a business model whose objective is to hold assets in order to collect contractual cash flows, and the instruments passes the "Solely Payments of Principal and Interest" (SPPI) test. As term deposits are plain vanilla and give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding, they meet the SPPI test.

- PBE IFRS 9 requires that financial assets are measured on acquisition at fair value. This includes an allowance for credit risk. However, so long as s.161 of the Crown Entities Act 2004 and the Crown Entities (Financial Powers) Regulations 2005 have been complied with, credit risk is minimal and can be assumed to have no effect on the value for reporting purposes.

If entities therefore can confirm that they hold term deposits to collect contractual cash flows, have made term deposits on the usual terms operated by banks, and have invested in low risk entities in accordance with the Crown Entities (Financial Powers) Regulations they can expect to be able to continue the amortised cost (face value plus accrued interest) approach previously taken.

# APPENDIX: PBE IFRS General Model for recognising impairment losses for advances and receivables

## The General Model

PBE IFRS 9 introduces a “general model” of recognising impairment losses for advances and receivables. This model requires recognising impairment losses in line with the stage in which the advance or receivable currently is. There are 3 stages:

| | **Stage 1** | **Stage 2** | **Stage 3** |
|---|---|---|---|
| Financial Asset | Performing | Increased Credit Risk | Credit Impaired |
| Loss Allowance | 12-month expected losses | Lifetime expected credit losses | Lifetime expected credit losses |
| Interest revenue | On gross carrying amount | On gross carrying amount | On amortised cost |

## Stage 1: Performing financial assets

For healthy financial assets that are expected to perform normally in line with their contractual terms where there are no signs of increased credit risk, PBE IFRS 9 requires a recognition of an impairment loss (doubtful debts provision) amounting to 12-month expected credit losses immediately at initial recognition of these assets.

This is the expected credit loss resulting from default events on a these financial assets that are possible within 12 months after the reporting date.

For these assets, interest revenue is recognised based on effective interest rate method on gross carrying amount, so no loss allowance is taken into account.

## Stage 2: Financial assets with significantly increased credit risk

When the credit risk of financial assets has significantly increased and the resulting credit quality is no longer low risk, then full lifetime expected credit losses need to be recognized.

These are the present value of losses that arise if a borrower defaults on their obligations throughout the life of the financial instrument. 12-month expected credit losses are just the portion of the life time expected credit losses.

Expected credit losses are a difference between the present value of cash flows based on the contract of a financial asset; and the present value of cash flows that are now expected from the financial asset. Therefore, the timing of receipts from the financial asset directly affects their present value and thus the amount of an impairment loss. If there is now an expectation that debtor will pay in full, but later than in accordance with the contract, there will be an impairment loss.

Interest revenue for stage 2 assets is calculated exactly in the same way as in stage 1 (on gross carrying amount).

## Stage 3: Credit-impaired financial assets

When a financial asset has already become credit impaired (i.e. that certain default events have occurred), then an entity still recognises lifetime expected credit losses.

However, from this point, interest revenue is calculated and recognised based on the amortised cost (that is gross carrying amount less loss allowance).

Such financial assets are likely to need to be individually assessed.

## This model is demanding

The correct application of this model requires significant reliable information, for example:

- information for estimating debtor's credit risk and identifying its significant increase
- information for estimating occurrence of default events within 12 months from the reporting date
- information for estimating occurrence of default events within the life of the instrument, their probable outcomes and weights.

Even slight changes in one of these parameters can affect the resulting amount of recognised impairment loss and thus financial results of an entity.