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CNOCP
Conseil de normalisation des comptes publics

Opinion n° 2012–04 of the 3rd July 2012 relating to accounting for financial debts and derivative instruments of public accounting entities within the scope of the General Code of Territorial Authorities, the Code for Social Action and Families, the Code of Public Health and the Code of Building and Housing

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MINISTÈRE DE L'ÉCONOMIE
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1. Objective and scope of the Opinion

The objective of this Opinion of the Public Sector Accounting Standards Council is to supplement and clarify the accounting rules for loans, derivative instruments and hedging transactions in order to improve the accounting representation of the risks incurred in connection with the subscription of certain loans, in particular structured loans.

The Council's Opinion also addresses hedge accounting transactions in which all or part of the risks relating to a loan are hedged by derivative instruments, as well as the accounting treatment of loan restructuring transactions.

In addition, the Council's Opinion also provides guidance on the accounting treatment of loans with beneficial interest rate features designed to defer interest payments. This accounting treatment sets out to present the periodic financial expense relating to a loan even when the interest payment occurs in subsequent periods.

The Opinion applies to public accounting entities within the scope of The General Code of Territorial Authorities, The Code for Social Action and Families, The Code of Public Health and the Code of Building and Housing.

Hereafter in this Opinion these entities are referred to as "local public entities".

2. Principal requirements

The guidance reflects the level of complexity and financial risk relating to loans.

2.1 Simple and complex products: definitions

A distinction is made between simple products and complex products which expose a local public entity to additional risk in exchange for an expected gain as compared to market conditions at the date the loan is subscribed. This distinction between simple and complex products is made on a case by case basis, according to the characteristics of the relevant financial instrument and its market context.

By way of illustration, transactions in categories above C or 3 in the classification of the "Gissler Chart" are presumed to be complex.

- ***Simple products***

Products classified as simple are products with a simple fixed or floating interest rate. These types of loan may expose their subscribers to opportunity losses in certain market conditions but do not expose the latter to financial expense that increases at a rate significantly different to that of the market.

- ***Complex products***

Complex products are those which, due to an unfavourable evolution of the rate of the loan, expose the borrower to the risk of borrowing at a rate far higher than it would have obtained by subscribing from the outset a simple fixed or floating rate loan. Complex products require risk evaluation on acquisition with an update on subsequent reporting dates and the risks are provided for accordingly.

- ***Complex products with a protection mechanism***

Structured products which, on the basis of their formula, are presumed complex, but which have a protection mechanism limiting the risk of an unfavourable change in interest rates, require further assessment. The mechanism may be included in the financial instrument or be acquired separately. If, on the basis of the assessment, the mechanism is judged to be effective, that is it ensures that the interest rate will not significantly exceed market rate over the term of the loan, the product is treated as a simple product in spite of the complexity of its formula. The effectiveness assessment must be carried out on a case by case basis taking into account market data, the complexity of the formula and of the reference rates used, as well as the term of the loan and its materiality for the local public entity. If the mechanism provides insufficient protection from an increase in interest rates, the loan remains classified as a complex loan.

2.2 Accounting treatment

The accounting treatment differs according to whether the loan is classified as a simple or a complex loan.

- ***Simple products***

Interest expense is recognized on an accruals basis.

- ***Specific case of loans with a beneficial interest rate***

When a loan has a beneficial interest rate over a part of its term, which has the effect of deferring interest payment, the deferral is effectively a cash facility and not a reduction in expense.

The beneficial effect is cancelled out and the annual interest expense recalculated and recognized for each period on the basis of the effective interest rate for the loan, when this rate can be calculated or otherwise at the original market rate. The difference between this interest expense and that calculated at the beneficial rate is recognized as prepaid revenue.

This information, in particular the original market rate, should be systematically provided. Once the beneficial interest period is complete, the amount of the expense is reversed over the residual term of the loan.

The amount of the interest rate benefit reversal, which is deducted from annual interest expense, is calculated using an actuarial method when the effective interest rate is used to cancel out the benefit. A simplified method, consisting of reversing the amount of the benefit on a straight-line basis over the residual term of the loan, is adopted when the benefit is cancelled out using the original market rate.

- ***Complex products***

In the case of complex transactions, including an additional risk component, the objective is to translate into the accounts the risk that the cost of the loan exceeds significantly market rates (Euribor, Libor, etc.) because of its structuring. These products generally offer a beneficial rate as compared to that which would have been obtained originally by subscribing a simple product. This benefit is the remuneration for the sale of an option generally included in these products; this sale of an option reflects the fact that in granting the loan the bank may benefit from the right to remuneration far superior to market rates under certain conditions depending on future changes in interest rates[1].

In the same way as for simple products, any benefit shall only be recognized when it is realized. This leads to recognizing annually the difference between interest expense at the effective interest rate [2] or at market rate and interest expense determined at the beneficial rate in prepaid revenue. This prepaid revenue is written back through surplus/deficit over the residual term of the loan.

[1] The bank may not necessarily keep the option afterwards.
[2] In practice, it is rarely possible to use an effective interest rate for this type of loan.

In order to recognize the additional risk, a financial evaluation of the risk included in the loan shall be carried out when the loan is first taken out, in general when the funds are transferred[3].

If this evaluation shows that there is a risk superior to the amount of the benefit obtained, then a provision is set up for the amount of the difference.

The risk is re-estimated at each reporting date on the basis of market rate anticipations.

A second option would be to adopt the same approach, but by calculating the original amount of the benefit and the excess expense of the following periods by reference to the fixed market rate at the outset.

- ***Complex products with a protection mechanism***

Any interest benefit is cancelled out and interest expense for the beneficial interest periods is measured by reference to an original market rate.

Once the beneficial interest period is complete, the amount of the benefit is reversed on a straight line basis over the remaining period. Interest expense for this period is equal to the interest calculated at the contractual rate for the loan less the amount of the reversed benefit.

Nevertheless, the reversal of the benefit should not lead to recognizing interest expense in surplus/deficit over the term of loan less than the amount that would have been recognized using the original market rate. Any remaining excess amount of the benefit is recognized in surplus/deficit at the maturity of the loan.

2.3 Hedging transactions

2.3.1 Definition of a hedging transaction

A hedging transaction consists of associating a hedged item and a hedging instrument in order to reduce the risk that the hedged exposure will have unfavourable effects on the surplus/deficit or net assets/equity of the entity.

After hedging the loan can be assimilated to a simple product.

Transactions including both a hedging component (which would meet the criteria for a hedge if the contract had taken that form) and an additional risk component require a different accounting treatment for each component which enables the additional risk to be provided for.

[3] This does not apply to short term credit facilities outside the scope of the Opinion.

2.3.2 Hedge accounting

✓ ***Hedging transactions without a risk component***

The pattern of recognition in surplus/deficit for the hedging instrument and the hedged item must be matched. Thus, unrealized or realized revenue and expense of the hedging instrument are recognized in surplus/deficit over the residual lifespan of the hedged item and matched with the revenue and expense of the latter.

✓ ***Hedging transactions including a risk component***

The hedging component and the risk component receive a separate accounting treatment as if the transaction had been carried out with two separate instruments:

- The hedging component is treated as a hedging transaction ;
- The remaining component which generates additional risk for the entity is provided for using the same approach as for the risk component of a complex loan.

2.4 Debt restructuring

2.4.1 Definition of a debt restructuring transaction

Local public entities often carry out loan renegotiations which take different forms and must receive a consistent accounting treatment, however the renegotiation is structured, whether:

- compensation is paid immediately,
- compensation is capitalized,
- compensation is included in the financial conditions of the new loan (i.e. included in future interest).

The amount of the restructuring compensation should therefore be identified; this information is either obtained directly from the counterparty, or by comparing the net present value (NPV) of the old and the new loan which should be systematically provided.

2.4.2 Accounting treatment

The compensation is included in expense for the period. It may be deferred over a period which must not exceed the residual term of the initial loan before renegotiation or over the term of the new loan if it is shorter.

When several loans are restructured and a single compensation payment is made for all of them, the expense shall be deferred over the weighted average of the residual term of the different loans before renegotiation or over the term of the new loan if that is shorter.

Where there is a residual balance of deferred benefit for a renegotiated loan, the remaining amount of the benefit is offset against the cost of compensation before deferral of the latter.

3. Qualification of the change and effective date

The first application of this Opinion consists of a change in accounting policy.

Thus, on the first application date of the requirements, a risk evaluation shall be carried out for loans taken out before the adoption of the Opinion that have the characteristics of a complex loan and a provision made if applicable. The full amount of the provision is recognized directly in net assets/equity.

The first application of this Opinion has no accounting consequences for simple loans including those with a beneficial interest period.

The Opinion is applicable to accounting periods as from 2013 (accounts closed the 31st December 2013).