

## **QAO Guideline - Accounting for QTC Onlending Products and Debt Restructure**

QAO, in conjunction with the Queensland Treasury Corporation (QTC), has considered a number of issues in regard to debt restructure, including -

- Australian Accounting Standards and Guidance Releases
  - AAG 11 Debtor's - Accounting for Debt Restructuring
  - AAS 23/AASB 1014 - Set-off and Extinguishment of Debt
- Other accounting standards that deal with valuation
- The QTC products on issue
- The intentions of management
- Fixed interest markets

However, the guidance in the accounting standards is far from definitive and is likely to require interpretation in each instance.

Australian Accounting Standards are, in principle, adopting measurement approaches that attempt to measure the gross inflow or outflow or enhancement or consumption of future economic benefits. The general thrust of the accounting standards is to identify current values and returns. In many standards, matching is diminishing in use as a basis for accounting.

One principle that has relevance to the current cost approach is the intention of management to manage debt and interest rate risk. On this basis it is conceivable that management can structure debt in such a way that movements in current market values do not impact on the long term cost of funding. The broad intentions of management should relate specifically to products provided by QTC. On this basis there are three broad methods that relate to QTC products and hence three cost measurement approaches. These are-

### **1. Repayment Profile Book Rate Methodology**

This methodology is suited for Generic Debt Pool clients as their repayment profiles are, in general, well defined.

The Book Rate is based on the expected repayment profile of the account (usually standard principal and interest). It is determined by calculating a rate to apply to the Book Value such that the Book Value and Market Value should extinguish together. To do this, the account is modelled using market interest rates to determine what payments are required to repay the Market Value of the account. The Book Rate is then calculated such that the Book Value is also repaid with these payments. This methodology should ensure that the Book Value and Market Value of the account will extinguish at the same time. If they do not extinguish at the same time, the timing difference will be insignificant.

The Book Rates for all Generic Debt Pool accounts are monitored on a quarterly basis and the implementation of a Book Rate review is dependent on how significant the change in the Book Rate is, and the expected term to repayment of the loan. The shorter the term to repayment the more likely that the Book Rate will be changed.

### **2. Benchmark Funding Book Rate Methodology**

This methodology may be used for Client Specific Pool clients. The Book Rate is reviewed on a regular basis as agreed between QTC and the client (e.g. monthly or quarterly). Implementation of the reviewed Book Rate occurs regardless of how large or small the change is.

The Book Rate is calculated by combining a fixed Book Rate with a floating rate, based on the benchmark fixed/floating mix. The fixed Book Rate is calculated by calculating a rate to repay the fixed component of the book value with the underlying cashflows of the benchmark portfolio (e.g. coupons and face values). The floating Book Rate is the market rate at the time of the review based on the review frequency. For example, if the Book Rate is reviewed monthly then a one month floating rate is used.

### 3. Par Bond Book Rate Methodology

This methodology may be used for Client Specific Pool clients. The frequency of review is dependent on the agreement between QTC and the client. A notional repayment term is required for the calculation. This notional term may be the result of a regulatory rate reset cycle or based on the underlying asset profile of the client.

The Book Rate is calculated by determining what rate is to be applied to the Book Value such that after taking into account Book Interest Payments (based on this rate), the Market and Book Values are equal at the end of the notional period.

All methods take into account the difference between the Book Value and Market Value on the review date. The objective of the Book Rate review is to minimise the chances of the Book Value and Market Value diverging over time. Book and Market Values can diverge over time due to factors such as -

- Movements in floating market interest rates
- Changes to the benchmark composition or repayment profile
- Interest rate risk management
- Mismatches between the funding and repayment profiles
- Client transactions (advances and redemptions)
- Delays in implementing the reviewed Book Rate from previous periods

To further clarify the different methods and the impact on the accounting treatment, the following table summarises the different methods across a number of situations and the conditions that require a review to the Book Rate -

<b>Situation</b>	<b>Repayment Profile Book Rate Methodology</b>	<b>Benchmark Funding Book Rate Methodology</b>	<b>Par Bond Book Rate Methodology</b>
Initial Book Rate Setting	Based on the repayment profile of the loan advance and prevailing market interest rates	Weighted average of the fixed and floating rates. The fixed rate is the rate based on the cash flows of the benchmark and the market value which extinguishes the book value debt. The floating rate is the current market rate which relates to the frequency of review.	The rate, based on prevailing market interest rates, which applies to the interest only payment profile for the notional repayment term specified.
Impact of New Borrowings	The Book Rate of new borrowings are weight averaged with the existing book value debt and Book Rate.	There is no change to the Book Rate at the time of the borrowing (unless the benchmark profile is changed and this will impact the reviewed Book Rate at the next review date).	There is no change to the Book Rate at the time of the borrowing.

<b>Situation</b>	<b>Repayment Profile Book Rate Methodology</b>	<b>Benchmark Funding Book Rate Methodology</b>	<b>Par Bond Book Rate Methodology</b>
Impact of Repayments (other than Debt Service Payments).	The book value debt will be adjusted by a market realisation charge when a repayment is made. The realisation charge is such that the ratio of the level of the book value debt to the market value debt is kept the same. Since the repayment profile has been altered, a Book Rate Review should be undertaken at this time.	In general, the book value debt will be adjusted by a market realisation charge when a repayment is made. The realisation charge is such that the ratio of the level of the book value debt to the market value debt is kept the same.	In general, the book value debt will be adjusted by a market realisation charge when a repayment is made. The realisation charge is such that the ratio of the level of the book value debt to the market value debt is kept the same.
Impact of Changes to the Underlying Instruments Funding the Debt.	No change to the Book Rate if changes to the underlying funding instruments are made (either benchmark or actual).	No change to the Book Rate if the underlying funding instruments of the actual portfolio are made. However, a change will occur at the next review date if the benchmark profile changes.	No change to the Book Rate if the underlying funding instruments of the actual and benchmark portfolio are made.
Divergence of Book Value Debt and Market Value Debt over time.	By monitoring the Book Rate at regular intervals, the book value debt and market value debt should not diverge significantly over the term of the loan.	Although the loan is assumed to be ongoing, the methodology assumes that book value debt and market value debt will extinguish over the cash flow profile of the benchmark portfolio. The Book Rate review will pick up changes to the profile of the benchmark over time.	Although the loan is assumed to be ongoing, the methodology assumes that the book value debt and market value debt will equate at the end of the notional repayment term.

<b>Situation</b>	<b>Repayment Profile Book Rate Methodology</b>	<b>Benchmark Funding Book Rate Methodology</b>	<b>Par Bond Book Rate Methodology</b>
Frequency of Review	Book Rates are monitored on a quarterly basis. However, the decision to review the Book Rate is based on significance of the change in the reviewed Book Rate, the expected term to repayment of the loan and the individual circumstances of the loan.	Based on the agreement between QTC and the customer (usually monthly or quarterly). At least annually, on or before 30 June.	Based on the agreement between QTC and the customer. At least annually, on or before 30 June.
In What Situations is the Difference Between the Book Value Debt and Market Value Debt be Taken To Profit and Loss?	When the criteria for debt re-structure have been met.	When the criteria for debt re-structure have been met.	When the criteria for debt re-structure have been met.
Can An Entity Direct That the Difference Between the Book Value Debt and Market Value Debt Be Taken to Profit and Loss?	If an entity wishes to change the method of accounting for debt to market value the difference must be taken to profit and loss.	If an entity wishes to change the method of accounting for debt to market value the difference must be taken to profit and loss.	If an entity wishes to change the method of accounting for debt to market value the difference must be taken to profit and loss.

In general, these are the arrangements that apply to QTC customers. If these arrangements are varied for a particular customer, then the implications of this should be discussed with QAO.

### **Guidance on Debt Restructure Principles**

In conjunction with the Book Rate methodology principles outlined above, the following broad principles are considered to apply -

- (a) If an entity alters its arrangement with QTC for the purposes of interest rate risk management the debt is not considered to be restructured. If however the entity alters its arrangement with QTC for what could constitute reporting purposes or where it could be concluded that debt and risk management are not the sole reasons for the change, the debt is considered to be restructured. Therefore, when a change to interest rate risk parameters (benchmark profile) is undertaken a justification of the change by the entity is required with respect to the operations of the business.

AND

- (b) If an entity alters the composition of instruments that fund their onlending but does not induce significant refinancing risk the debt may not be considered to be restructured.

If however an entity significantly alters the composition of instruments that fund their onlending and exposes a significant refinancing risk then the debt could be considered to be restructured.

Significant refinancing risk is viewed as an indicator of significant change to the underlying composition of instruments. Whether refinancing risk is significant is a judgement call and should be considered on a case by case basis. Examples of refinancing risk are provided below -

- Significant refinancing risk - On one day QTC buys back \$1 billion of 2005 stock and issues \$1 billion of 2009 stock.
- Insignificant refinancing risk - Over a period of three months QTC buys back \$1 billion of 2005 stock and issues \$1 billion of 2009 stock.

The principles outlined above are based on QAO's understanding of current QTC products and arrangements. The principles are a guide only and may change as a result of changes to Accounting Standards, QTC financing arrangements, Queensland Government Policy, etc. The guideline may not cover all future situations and accordingly if there is uncertainty you should contact your QAO Client Service Representative.