



To:	AASB Members	Date:	16 July 2009
From:	Natalie Batsakis and Jim Paul	Agenda Item:	8.1
Subject:	ED 37 <i>Financial Instruments: Presentation</i> , ED 38 <i>Financial Instruments: Recognition and Measurement</i> and ED 39 <i>Financial Instruments: Disclosures</i>	File:	

Action

Consider the attached draft submission to the IPSASB on Exposure Drafts ED 37 *Financial Instruments: Presentation*, ED 38 *Financial Instruments: Recognition and Measurement* and ED 39 *Financial Instruments: Disclosures*, particularly the matters for Board consideration outlined below, and provide staff with directions for finalising the submission to be sent by 31 July 2009.

Background

At its June 2009 meeting, the Board discussed a number of issues that it considers would be relevant to the IPSASB's redeliberation of the proposals in EDs 37, 38 and 39. Staff's understanding of the Board's views on those issues have been incorporated into the draft submission in Agenda Paper 8.1A for this meeting.

Matters for the AASB's Consideration

In preparing the Board's draft submission to EDs 37, 38 and 39, staff identified the following matters that it considers to be relevant to the AASB's deliberations on Agenda Paper 8.1A.

Accounting for financial guarantee contracts issued in a non-exchange transaction

The IPSASB proposes in ED 37 that financial guarantee contracts issued through non-exchange transactions (i.e. for no or nominal consideration) should be accounted for in accordance with the IPSAS equivalent to IAS 39 and not be subject to the conditional option in IFRSs to be recognised and measured as insurance contracts.

The AASB disagreed with this proposal at its June 2009 meeting, based on the fact that there is no public sector specific reason to depart from IFRSs in this instance and that the liability adequacy test in IFRS 4 *Insurance Contracts* would require recognition of financial guarantee obligations arising from non-exchange transactions because it focuses on cash outflows arising from honouring the obligation rather than the amount, if any, paid as compensation for incurring the financial guarantee obligation. The response to Question 1 in Appendix A to the letter reflects our understanding of the Board's preliminary view from that meeting.

However, on reflection, staff note the concern that some national accounting standards dealing with insurance contracts may not have an equivalent 'liability adequacy test', and that could result in financial guarantee obligations issued through a non-exchange transaction being measured at zero (in effect, not recognised). Therefore, in the absence of an IPSAS-equivalent to IFRS 4, and until such an IPSAS-equivalent is developed, staff are satisfied that the IPSASB's proposed approach is a reasonable response to the concern that financial guarantee contracts issued through a non-exchange transaction might not be recognised.

Staff note that this is a less significant issue for financial guarantee contracts issued through an exchange transaction because the transaction price for issuing the financial guarantee contract provides a basis for initial measurement of the financial guarantee obligation at an amount greater than zero.

Staff recommendation

Based on the above analysis, staff accept there is a public sector/non-exchange specific reason, at least for now, to depart from IFRSs regarding the treatment of financial guarantee contracts issued through a non-exchange transaction as either financial instruments or insurance contracts.

Staff considered whether a condition could be placed in paragraph 3(c)(iii) of the IPSAS developed from ED 37 that required entities applying a national accounting standard dealing with insurance contracts in recognising and measuring financial guarantee contracts, to apply the same liability adequacy test as that set out in IFRS 4. However, staff concluded that including such a provision would involve clumsy drafting, probably require re-exposure of the proposed IPSAS and result in 'back door' adoption of part of an IFRS that has yet to be considered by the IPSASB.

Therefore staff support the proposal in paragraph 3(c)(i) of ED 37 that financial guarantee contracts issued through non-exchange transactions should be required to be accounted for in accordance with the IPSAS-equivalent to IAS 39.

An alternative response based on the staff recommendation has been included as 'boxed text' in the response to Question 1 in Appendix A to the letter for the Board's consideration.

Question for Board members:

Do you agree with the staff recommendation to support the IPSASB's decision to treat financial guarantee contracts issued through a non-exchange transaction in accordance with an IPSAS-equivalent to IAS 39 and not provide the conditional option in existing IAS 39 requirements?

Measuring financial guarantees on initial recognition

The IPSASB proposes to measure financial guarantees at initial recognition in accordance with IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets* where no fee is paid or where the consideration is not at fair value and where a fair value measurement cannot be obtained through observation of an active market (Level 1) or through another valuation technique other than observation of an active market that provides a 'reliable measure of fair value' (Level 2).

The AASB disagreed with this proposal at its June 2009 meeting, stating that there is no public sector specific reason to initially measure financial guarantees in accordance with IPSAS 19 where fair value cannot be 'reliably measured', and tentatively decided to comment that the IPSASB should retain the requirements currently in IAS 39 to measure all financial guarantees on initial recognition.

On subsequent consideration of the issue, staff note that IAS 39 requires financial instruments be measured on initial recognition at fair value and that the transaction price on initial recognition is the best evidence of fair value. However, the last sentence of paragraph AG107 of the proposed IPSAS equivalent to IAS 39 says: "The best evidence of the fair value of a financial instrument at initial recognition is the transaction price ... unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets" (emphasis added).

A consequence of this is that a concessionary loan issued through a non-exchange transaction without any observable current market transactions, would be recognised at the transaction price which would not faithfully represent fair value.

Staff recommendation

Staff consider that there will be various instances in which financial instruments (or items treated as financial instruments) are created through non-exchange transactions, such as concessionary loans or some financial guarantees. In these instances the transaction price will not be the best evidence of fair value at initial recognition, but there will not exist the market evidence proposed to be required by paragraph AG107 to 'move off' the transaction price at initial recognition.

Therefore, in addition to disagreeing with the IPSASB's proposal to measure financial guarantees at initial recognition in accordance with IPSAS 19 where a reliable measure of fair value cannot be determined, in order to avoid recognizing a concessionary loan at nil, staff think that paragraph AG107 of the proposed IPSAS equivalent to IAS 39 should be qualified to only apply to a transaction price in an exchange transaction. It could also, for example, be amended to go on to say something along the lines of: the best evidence of the transaction price for financial instruments in a non-exchange transaction can be a fair value measurement based on Level 3 inputs (and not just observable market data).

Question for Board members:

Do you agree with the staff recommendation in relation to accounting for concessionary loans in a non-exchange transaction?

Attachments

Agenda paper 8.1A Draft AASB submission to the IPSASB on Exposure Drafts ED 37 *Financial Instruments: Presentation*, ED 38 *Financial Instruments: Recognition and Measurement* and ED 39 *Financial Instruments: Disclosures*

A copy of EDs 37, 38 and 39 were included in the agenda papers for the AASB's June 2009 meeting (Agenda Paper 6D.1). Copies are available upon request to nbatsakis@aab.gov.au.