

**DRAFT**

XX July 2009

Ms Stephenie Fox  
Technical Director  
International Public Sector Accounting Standards Board  
International Federation of Accountants  
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Toronto, Ontario M5V 3H2 CANADA

Dear Ms Fox

**Exposure Draft ED 37 *Financial Instruments: Presentation***  
**Exposure Draft ED 38 *Financial Instruments: Recognition and Measurement***  
**Exposure Draft ED 39 *Financial Instruments: Disclosures***

The Australian Accounting Standards Board (AASB) is pleased to provide comments on the above-named IPSASB Exposure Drafts.

The AASB supports the IPSASB's programme to update convergence of accrual basis International Public Sector Accounting Standards (IPSASs) with International Financial Reporting Standards to the extent appropriate for public sector entities. Accordingly, the AASB agrees with the IPSASB's decision to use IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures* as the basis for EDs 37, 38 and 39 respectively.

The AASB considers that finalisation of these proposed IPSASs should be deferred until the IASB completes its short-term project to significantly amend IAS 39, in view of the duplication of cost and effort to constituents that would arise from implementing IPSAS-equivalents to both the current and revised versions of IAS 39. If the IPSASB proceeds with issuing these proposed IPSASs, it should explain how it intends to deal with the IASB's changes to IAS 39.

Subject to that concern, the AASB supports the proposals in EDs 37, 38 and 39, except for the matters noted below in relation to ED 37 and ED 38.

**ED 37**

In contrast to the proposal in ED 37, the AASB thinks that financial guarantee contracts issued through non-exchange transactions should, like those issued through exchange transactions, be subject to the conditional option in IFRSs to be recognised and measured as insurance contracts. [*Note to AASB members: this comment reflects our understanding of the Board's preliminary view based on the June 2009 Board discussion. It would not be made under the alternative view in the box in response to Question 1 in Appendix A.*]

## ED 38

In relation to ED 38, the AASB has concerns with:

- (a) the proposed distinction between concessionary loans and waivers of debt;
- (b) the proposed guidance on concessionary loans in paragraphs AG83 to AG89; and
- (c) the proposal to treat the fair value of some financial guarantees as not being reliably measurable and therefore require those financial guarantees to be measured on initial recognition in accordance with IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*.

These concerns regarding ED 37 and ED 38 are elaborated on in the Appendices to this letter.

The AASB appreciates the IPSASB providing mark-ups of the corresponding IFRSs to assist readers of the Exposure Drafts to focus only on the proposed changes to the text of those IFRSs and thereby consider whether there is a public sector specific basis for the proposed changes. This initiative significantly reduces the time spent in providing comments on the Exposure Drafts.

As a general matter of drafting of IPSAS-equivalents to IFRSs, the AASB recommends retaining the expression and style used in IFRSs, rather than tailoring them for the public sector (for example, replacing 'profit/loss' with 'surplus/deficit'). The AASB considers that the expression and style used in IFRSs are understandable in a public sector context, particularly because many entities applying IPSASs have referred to IFRSs for topics on which IPSASs do not exist, under the hierarchy of non-mandatory guidance in IPSAS 3 *Accounting Policies, Changes in Accounting Estimates and Errors*. Key advantages of retaining the expression and style used in IFRSs are:

- (a) it avoids any unintended changes in meaning that can arise from such redrafting ; and
- (b) it would save time and effort for IPSASB staff in developing the proposed IPSASs (because time would not be spent on such redrafting) and for readers of IPSASB exposure drafts (because they can focus only on any substantive differences from IFRSs).

The AASB notes that some editorial issues arise with these Exposure Drafts. AASB staff will provide editorial suggestions directly to IPSASB staff.

If you have any queries regarding any matters in this submission, please contact me or Natalie Batsakis ([nbatsakis@aab.gov.au](mailto:nbatsakis@aab.gov.au)).

Yours sincerely

Kevin M. Stevenson  
Chairman

**Exposure Draft 37 *Financial Instruments: Presentation*****Specific Matters for Comment**

1. ED 37 allows entities to treat financial guarantee contracts issued through an exchange transaction as insurance contracts if the issuer elects to recognize and measure them in accordance with the international or national accounting standard dealing with insurance contracts. However, all financial guarantee contracts issued at no or nominal consideration are required to be treated as financial instruments. Do you agree with this approach? Please state your reasons for either agreeing or disagreeing with this approach.

No, the AASB does not agree with the proposed approach, as explained below.

***Financial Guarantee Contracts should not be Treated Differently Depending on whether they are Issued through an Exchange Transaction or a Non-exchange Transaction***

The AASB does not believe that there is a public-sector-specific reason to treat financial guarantee contracts differently depending on whether they are issued through an exchange transaction or a non-exchange transaction. Accordingly, the AASB does not believe that a departure from IFRSs regarding the treatment of financial guarantee contracts issued through a non-exchange transaction as either financial instruments or insurance contracts (specifically, the conditional option provided in IAS 39 to account for some financial guarantee contracts under either IAS 39 or IFRS 4 *Insurance Contracts*) is appropriate.

Therefore, the AASB recommends amending ED 37 to omit scope paragraph 3(c)(i) and omit “by way of an exchange transaction” from scope paragraph 3(c)(iii). The AASB notes that paragraph 3(c)(iii) deals with the absence of an IPSAS equivalent to IFRS 4 by referring to “the relevant international or national accounting standard dealing with insurance contracts”, and agrees with that drafting device.

The AASB observes that a consequence of the absence of an IPSAS-equivalent to IFRS 4 is that the proposed IPSAS based on ED 37 would not invoke an equivalent ‘liability adequacy test’ to that contained in paragraphs 15 – 19 of IFRS 4. A liability adequacy test, if applied, would prevent non-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 to the public sector reporting entity as compensation for incurring the financial guarantee obligation.

Therefore, the AASB recommends including a condition in paragraph 3(c)(iii) of the IPSAS developed from ED 37 that, if an entity applies a national accounting standard dealing with insurance contracts in recognising and measuring financial guarantee contracts, it must apply the same liability adequacy test as that set out in IFRS 4. The AASB recommends including the wording of that test in the scope paragraph, rather than cross-referring to IFRS 4.

*Alternative to above part of response (recommended by AASB staff)*

The AASB agrees with some aspects of the proposed approach, but has concerns about other aspects, as explained below.

***Financial Guarantee Contracts should be Treated Differently Depending on whether they are Issued through an Exchange Transaction or a Non-exchange Transaction***

The AASB accepts the IPSASB's proposal to treat financial guarantee contracts differently depending on whether they arise from an exchange transaction or a non-exchange transaction, even though, ideally, the allowed treatments of financial guarantee contracts should not differ according to whether they are issued through an exchange transaction or a non-exchange transaction. The IPSASB's approach addresses the AASB's concern that, for financial guarantee contracts issued through a non-exchange transaction, in the absence of an IPSAS-equivalent to IFRS 4 *Insurance Contracts*, and until such an IPSAS-equivalent is developed, unless the IPSASB's approach is adopted, financial guarantee obligations might be measured at zero (in effect, not recognised) under some national accounting standards dealing with insurance contracts.

The reason for this concern is that, because of the absence of an IPSAS-equivalent to IFRS 4, the proposed IPSAS based on ED 37 would not invoke an equivalent 'liability adequacy test' to that contained in paragraphs 15 – 19 of IFRS 4. A liability adequacy test, if applied, would prevent non-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 to the public sector reporting entity as compensation for incurring the financial guarantee obligation.

The AASB regards the present absence of a liability adequacy test in IPSASs as 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.

Based on these factors, the AASB considers that:

- (a) for financial guarantee contracts issued through a non-exchange transaction, there is a public-sector-specific reason for departing from IFRSs regarding their treatment as either financial instruments or insurance contracts; but
- (b) for financial guarantee contracts issued through an exchange transaction, there is not a public-sector-specific reason for departing from IFRSs regarding their treatment as either financial instruments or insurance contracts.

The AASB considered suggesting including a condition in paragraph 3(c)(iii) of the IPSAS developed from ED 37 that, if an entity applies a national accounting standard dealing with insurance contracts in recognising and measuring financial guarantee contracts, it must apply the same liability adequacy test as that set out in IFRS 4. However, it considers 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 not been considered by the IPSASB.

Therefore, the AASB agrees with 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, until such a time as the IPSASB has an IPSAS-equivalent to IFRS 4

***Consistency with IFRSs regarding the Circumstances in which Financial Guarantee Contracts may be Recognised and Measured under Accounting Standards dealing with Insurance Contracts***

The AASB considers that, under paragraph 3(c)(iii) of the IPSAS developed from ED 37, application of a relevant international or national accounting standard dealing with insurance contracts in recognising and measuring financial guarantee contracts should be subject to the same conditions that IFRS 4 imposes on treating financial guarantee contracts as insurance contracts. This applies regardless of whether paragraph 3(c)(iii) of the IPSAS developed from ED 37 applies to all financial guarantee contracts or only to those issued through an exchange transaction (see the comments on the issue above).

Under paragraph 4(d) of IFRS 4:

- (a) IFRS 4 may be applied if the issuer of a financial guarantee contract has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts; and
- (b) the election of whether to apply IFRS 4 or the Financial Instruments Standards to a financial guarantee contract is irrevocable.

Paragraph 4(d) of IFRS 4 is invoked by scope paragraph 4(d) of IAS 32, but there is no equivalent reference in paragraph 3(c)(iii) of IPSASB ED 37. Therefore, under paragraph 3(c)(iii) of ED 37:

- (a) an entity that elects to apply IFRSs in recognising and measuring financial guarantee contracts could account for those contracts as insurance contracts under the conditions imposed by paragraph 4(d) of IFRS 4; but
- (b) an entity that elects to apply a national accounting standard dealing with insurance contracts in recognising and measuring financial guarantee contracts potentially could account for those contracts as insurance contracts without any conditions (for example, regardless of previous treatment and without making an irrevocable election). Whether any conditions on that election would exist would depend on the scope paragraphs of the national accounting standard applied.

The AASB considers there is no public-sector-specific reason for more permissive use of national accounting standards dealing with insurance contracts when recognising and measuring financial guarantee contracts. Therefore, it recommends amending paragraph 3(c)(iii) of IPSASB ED 37 to permit application of a national accounting standard dealing with insurance contracts in recognising and measuring financial guarantee contracts *provided that*:

- (a) the issuer of a financial guarantee contract has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts; and
- (b) the election of whether to apply that standard or the Financial Instruments IPSASs to a financial guarantee contract is irrevocable.

2. The transitional provisions to ED37 do not provide any relief for entities initially adopting accrual accounting from preparing and presenting comparative information. Do you support this proposal? If additional transitional provisions are necessary, please indicate what these should be and state your reasons.

Yes. The AASB supports the transitional provisions in ED 37.

## **Exposure Draft 38 *Financial Instruments: Recognition and Measurement***

### **Specific Matters for Comment**

1. Do you agree with the Application Guidance relating to the issuer of concessionary loans (paragraphs AG83 to AG89), in particular:
- (a) The requirement that any difference between the transaction price of the loan and fair value of the loan at initial recognition should be expensed;
  - (b) The distinction between concessionary loans and the waiver of debt?
- If you do not agree with the Application Guidance please give your preferred alternative approach and state your reasons.

The AASB believes that the proposed guidance relating to the issuer of concessionary loans provided in paragraphs AG83 to AG89 is consistent with the requirements and guidance regarding low interest or interest-free loans in IAS 39. Therefore, the AASB agrees that any difference between the transaction price of the loan and fair value of the loan at initial recognition should be expensed.

However, the AASB questions whether the distinction between concessionary loans and waivers of debt is necessary. A concessionary loan would be accounted for in accordance with the low interest and interest-free loans guidance in the IPSAS-equivalent to IAS 39, whereas a waiver of debt would be accounted for in accordance with the impairment guidance in that Standard. If the IPSASB considers that such a distinction is necessary in the public sector, despite the other guidance present in the proposed IPSAS, then the treatment of waivers of debt should be clarified in the guidance.

In addition, the AASB believes that the proposed guidance in paragraphs AG83 to AG89 should be reviewed and, where appropriate, amended to:

- (a) avoid repetition of guidance that already exists in IAS 39;
- (b) acknowledge in the first sentence of proposed paragraph AG87 that ‘concessionary loans’ could involve *both* an in-substance loan (at an initial carrying amount of fair value plus, in the case of a financial asset or financial liability not at fair value through surplus or deficit, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability) and a ‘contribution from owners’ for the difference between the loan proceeds and the initial carrying amount of the loan. The first sentence of paragraph AG87 indicates that the substance of a ‘concessionary loan’ could be a loan, a grant *or* a contribution from owners;
- (c) reflect that the initial carrying amount of a concessionary loan asset or liability would be the loan’s fair value plus, in the case of a financial asset or financial liability not at fair value through surplus or deficit, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability (proposed paragraphs AG86 and AG88, respectively, imply and indicate that the initial carrying amount of a concessionary loan asset or liability would in all cases be the loan’s fair value, without adjustment for transaction costs);

- (d) consistent with (b) above, acknowledge in proposed paragraph AG88(b) that the difference between the loan proceeds and the initial carrying amount of the loan granted could be a distribution to owners, rather than an expense; and
- (e) ensure the requirements of the IPSAS-equivalent to IAS 39 and IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)* would result in consistent accounting outcomes, for example, in taking transaction costs into consideration. For example, under the proposals in paragraph 45 of ED 38, the initial carrying amount of a financial asset would be its fair value plus, in the case of a financial asset not at fair value through surplus or deficit, transaction costs that are directly attributable to the acquisition of the financial asset. That proposal applies regardless of whether the financial asset arose from an exchange or non-exchange transaction. However, paragraph 42 of IPSAS 23 specifies that an asset acquired through a non-exchange transaction shall initially be measured at its fair value as at the date of acquisition (that is, without adjustment for transaction costs), and IPSAS 23 does not scope out non-exchange transactions giving rise to financial assets.

2. Do you agree with the Application Guidance relating to financial guarantees provided for nil or nominal consideration (paragraphs AG91 to AG96), in particular that entities should apply a mathematical valuation technique to obtain a fair value where this produces a reliable measure of fair value? Alternatively, where a fair value cannot be obtained through observation of an active market, do you think that initial recognition should be in accordance with IPSAS 19, “Provisions, Contingent Liabilities and Contingent Assets.” Please state your reasons.

The AASB agrees that a valuation technique should be used to determine the fair value of financial guarantees provided for nil or nominal consideration where comparable transactions cannot be observed in an active market. This is consistent with existing guidance in IAS 39 to measure financial instruments at fair value. Therefore, the AASB concurs with the proposed guidance provided in paragraphs AG91-AG93.

However, the AASB does not agree with the proposal in paragraph AG96 to require a non-fair value measurement basis for financial guarantees at initial recognition 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).

IAS 39 does not have a reliability threshold for measuring financial instruments, other than equity instruments. Therefore, requiring initial measurement of financial guarantees in accordance with IPSAS 19 where fair value cannot be ‘reliably measured’ would be inconsistent with the existing IAS 39 requirements, with no public-sector-specific reason for being so. In addition, the AASB believes a requirement to measure some financial guarantees under IPSAS 19 would be inconsistent with the direction of the IASB’s short-term project to replace IAS 39 [under which the cost exemption would be removed and equity instruments (the measurement of which was previously deemed not to be reliably measurable) would be measured at fair value by utilising a Level 3 measurement using inputs based on management expectations in a valuation technique).

In addition, the IASB is proposing to broadly adopt the requirements in SFAS 157 *Fair Value Measurements* as a Standard in its current Exposure Draft ED/2009/3 *Fair Value Measurements*, which was issued in June 2009.

Based on this, the AASB believes that the IPSASB should retain the requirements currently in IAS 39 to measure all financial guarantees on initial recognition at fair value (utilizing Levels 1, 2 or 3).

***A Related Issue: when the Transaction Price is not the Best Evidence of the Fair Value of a Concessionary Loan or Financial Guarantee***

Proposed paragraphs AG86 – AG87 (in relation to the fair value of concessionary loans) and proposed paragraphs AG93 – AG94 (in relation to the fair value of financial guarantees issued for no or nominal consideration) indicate that the transaction price on initial recognition of a concessionary loan or financial guarantee issued for no or nominal consideration might not be its fair value. The AASB supports that guidance.

However, the AASB notes that the last sentence of paragraph AG107 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”.

The AASB considers that in 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, 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.

The AASB suggests that, to remove the potential inconsistency between proposed paragraph AG107 and the other above-mentioned paragraphs, consideration be given to qualifying the last sentence of paragraph AG107 as applying to a transaction price in an exchange transaction. In addition, the AASB suggests that the IPSASB consider amending proposed paragraph 107 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).

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| <p>3. Do you agree with the transitional provisions in paragraphs 114 to 123? If you do not agree with these transitional provisions please indicate further transitional provisions that are necessary, or those transitional provisions that are unnecessary. Please state your reasons.</p> |
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Yes. The AASB supports the transitional provisions in ED 38.

**Exposure Draft 39 *Financial Instruments: Disclosures*****Specific Matter for Comment**

The IPSASB considered all of the required disclosures in IFRS 7 to assess whether any disclosures should be deleted for public sector specific reasons. Examples of disclosures specifically considered include sensitivity analyses and collateral. The IPSASB concluded that there is no public sector specific reason to depart from the requirements of IFRS 7 by deleting any disclosures. Do you agree?

Yes. The AASB agrees that there is no public-sector-specific reason to depart from the requirements of IFRS 7 and therefore all the disclosure requirements should be retained.