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Ms Stephenie Fox
Technical Director
International Public Sector Accounting Standards Board
International Federation of Accountants
277 Wellington Street, 4th Floor
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 agreed with the IPSASB's original 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.

However, the AASB recommends that the IPSASB reconsider its position and defer its decision-making until the IASB completes its short-term project to significantly amend IAS 39. It would be unfortunate if entities faced a duplication of cost and effort from implementing, within a relatively short time, 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, and when, it intends to deal with the IASB's changes to IAS 39. For example, would it consider finalising the proposals but making their implementation optional pending revisions to IAS 39.

Subject to that concern, the AASB generally 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 relation to ED 37, the AASB has concerns with:

(a) the proposal to treat financial guarantee contracts differently according to whether they arise from exchange or non-exchange transactions, and require financial guarantee contracts issued at no or nominal consideration to be treated as financial instruments; and

(b) the proposal that an entity can elect to apply a national accounting standard dealing with insurance contracts in recognising and measuring financial guarantee contracts without making an irrevocable election, which is more permissive than the corresponding requirement in IAS 39.

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;

(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*;

(d) the proposed guidance that the fair value of a financial instrument arising from a non-exchange transaction can only differ from the transaction price on initial recognition if that different measurement is evidenced by observable market data (Level 1 or 2 measurement inputs);

(e) the clarity of the interaction between ED 38 and IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)* in relation to the initial and subsequent recognition of financial liabilities arising from non-exchange transactions; and

(f) for financial assets and financial liabilities arising from non-exchange transactions, inconsistencies between the proposed initial measurement basis under IPSAS 23 and the proposed subsequent measurement basis ED 38.

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.

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@aasb.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.

The AASB has the following comments in respect of the treatment of financial guarantee contracts.

Financial Guarantee Contracts should only be Treated Differently in Certain Circumstances

The AASB disagrees with the proposal to treat financial guarantee contracts differently according to whether they arise from exchange or non-exchange transactions. It considers that, if an issuer of financial guarantee contracts arising from either exchange or non-exchange transactions has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, it should be permitted to apply to such financial guarantee contracts either the IPSAS equivalent to IAS 39 (developed from ED 38) or the relevant international or national accounting standard dealing with insurance contracts. However, it also considers that application of a national accounting standard dealing with insurance contracts should be permitted only if that standard contains a liability adequacy test consistent with that contained in paragraphs 15 – 19 of IFRS 4 *Insurance Contracts*, and until the effective date of any IPSAS equivalent to IFRS 4.

The AASB notes that a reason for requiring all financial guarantee contracts issued through non-exchange transactions to be treated as financial instruments is that such contracts might otherwise be measured at zero (in effect, not recognised) if the entity decides to treat these instruments as insurance contracts, and the national accounting standard dealing with insurance contracts that it applies does not have a liability adequacy test equivalent to that in 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 considers that its proposal to permit application of a national accounting standard dealing with insurance contracts only if that standard contains a similar liability adequacy test to that in IFRS 4 would avoid the concern noted above.

Where this condition is not met, regardless of whether the financial guarantee contract arose from an exchange or non-exchange transaction, the AASB considers that the contract should be recognized and measured in accordance with the IPSAS equivalent to IAS 39.

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 the application of a relevant national accounting standard dealing with insurance contracts in recognising and measuring financial guarantee contracts arising from exchange transactions should be subject to the same conditions that IFRS 4 imposes on treating financial guarantee contracts as insurance contracts.

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 2(e) of IAS 39, but the reference to 'irrevocable' application has not been retained in equivalent paragraph 2(e) of IPSASB ED 38. Therefore, an entity can elect to apply either a national accounting standard dealing with insurance contracts or the Financial Instruments IPSASs in recognising and measuring financial guarantee contracts without making an irrevocable election, unless the scope paragraphs of the relevant national accounting standard applied have such a condition.

The AASB considers there is no public-sector-specific reason for providing a revocable election of which accounting standard(s) to apply when recognising and measuring financial guarantee contracts. Therefore, it recommends amending paragraph 2(e) of IPSASB ED 38 to reinstate the requirement that the election of whether to apply that a national accounting standard dealing with insurance contracts or the Financial Instruments IPSASs to a financial guarantee contract is irrevocable.

Because the AASB disagrees with the proposal to treat financial guarantee contracts differently according to whether they arise from exchange or non-exchange transactions, these comments apply equally to financial guarantee contracts arising from exchange and non-exchange transactions.

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 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 (initially measured at fair value) and a 'contribution from owners' for the difference between the loan proceeds and the initial fair value 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; and

(c) consistent with (b) above, acknowledge in proposed paragraph AG88(b) that the difference between the loan proceeds and the initial fair value of the loan granted could be a distribution to owners, rather than an expense.

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 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:

(a) no fee is paid or the consideration is not at fair value; and

(b) 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, for no apparent public-sector-specific reason. 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).

Furthermore, the IASB is proposing to broadly adopt the requirements in SFAS 157 *Fair Value Measurements* as a Standard in its current Exposure Draft ED/2009/5 *Fair Value Measurement*, which was issued in May 2009.

For these reasons, 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 (utilising Levels 1, 2 or 3).

A Related Issue: When the Transaction Price is Not the Best Evidence of the Fair Value of a Financial Instrument Created Through a Non-Exchange Transaction

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 AG107 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)'.

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.

Yes. The AASB supports the transitional provisions in ED 38.

Other Issues

Interaction with IPSAS 23

<u>Recognition</u>

The AASB suggests that the IPSASB considers whether the principles in the IPSAS equivalent to IAS 39 (ED 38) and IPSAS 23 would result in consistent identification of financial liabilities arising from non-exchange transactions. For example, the AASB notes that, in the circumstances described in paragraph 24 of IPSAS 23 (regarding funds contributed on the stipulation that the recipient obtains a matching contribution or returns the contribution), a liability would not be identified under IPSAS 23, although a financial liability would be identified if the principles in ED 38 were applied.

One interpretation of the effect of scope paragraph 2(j) of ED 38 is that a liability would not be recognised subsequently under the IPSAS equivalent to IAS 39 unless and until a liability is recognised under paragraph 24 of IPSAS 23. Under this interpretation, IPSAS 23 would seem to override the recognition requirements in IAS 39. This interpretation is based on a view that subsequent recognition and measurement of a liability can only occur if the liability has previously been recognised.

Alternatively, scope paragraph 2(j) of ED 38 could be interpreted as requiring subsequent recognition and measurement under the IPSAS equivalent to IAS 39 regardless of how the liability was treated initially. This interpretation is supported by the penultimate sentence of paragraph AG90 of ED 38, which says "Where these assets and liabilities[1] arise out of contractual arrangements and otherwise meet the definition of a financial instrument, they are subsequently measured and derecognized in accordance with this Standard." (This point is reiterated in the last sentence of paragraph BC6 and in paragraph BC7 of the Basis for Conclusions on ED 38.)

The AASB is unsure which of these interpretations was intended by the IPSASB.

The AASB suggests that the IPSASB clarifies the interaction of the IPSAS equivalent to IAS 39 and IPSAS 23 in relation to the initial and subsequent recognition and measurement of financial liabilities arising from non-exchange transactions, so that its intentions are clear.

<u>Measurement basis</u>

The AASB notes that ED 38 (paragraph 2(j)) proposes that IPSAS 23 should be applied to the initial measurement of financial assets and financial liabilities arising from non-exchange transactions. IPSAS 23 requires:

(a) an asset acquired through a non-exchange transaction to be measured initially at its fair value as at the date of acquisition (paragraph 42); and

(b) the amount recognized as a liability to be the best estimate of the amount required to settle the present obligation at the reporting date, consistent with IPSAS 19's measurement basis for provisions (paragraphs 57 – 58).

ED 38 proposes that:

(a) the IPSAS developed from ED 38 should apply to the subsequent measurement of financial assets and financial liabilities arising from non-exchange transactions; and

(b) with certain exceptions, financial assets and financial liabilities should subsequently be measured at fair value or amortised cost.

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[1] That is, "assets and liabilities resulting from non-exchange revenue transactions".

Therefore, on subsequent measurement:

(a) financial assets measured at amortised cost would be restated from initial fair value to an amount that takes into account transaction costs directly attributable to the acquisition of those assets (because amortised cost takes into account initial fair value plus directly attributable transaction costs). That is, directly attributable transaction costs would be excluded from initial measurement of those assets but included in their subsequent measurement; and

(b) financial liabilities other than 'advance receipts' would generally be remeasured from an initial measure determined consistently with IPSAS 19 to their fair value or amortised cost.

The AASB considers that these changes in measurement bases from initial measurement to subsequent measurement would be inappropriate, and suggests that the IPSASB reviews these measurement requirements for consistency. One means of avoiding inconsistency would be to amend IPSAS 23 (paragraphs 42 and 57) to specify that, on initial recognition, financial assets and financial liabilities arising from non-exchange transactions should be measured in accordance with the IPSAS developed from ED 38. Such an approach would be consistent with the consequential amendment to IPSAS 23 proposed in IPSASB ED 36 *Agriculture* to require biological assets and items of agricultural produce acquired through non-exchange transactions to be measured initially and subsequently on a consistent basis.

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 IPSAS 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.