



Accounting Standards Board

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Stephenie Fox,
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International Federation of Accountants,
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28 July 2009

Dear Stephenie

IPSASB Exposure Drafts on Financial Instruments (EDs 37-39)

1. The UK Accounting Standards Board's Committee on Accounting for Public Benefit Entities (CAPE) welcomes the opportunity to comment on the proposed IPSASs set out in the above exposure drafts.
2. We believe that, in order for IPSASs to form a credible foundation for financial reporting by the public sector, they must contain standards on financial instruments that are comprehensive, contain appropriate guidance on the fundamental issues that arise in the public sector, and, except where modifications are appropriate to deal with the public sector context, are converged with IFRSs. We understand that IPSASB shares that view.
3. As you know, IASB is currently conducting a major review of IAS 39 and this is expected to lead to substantial revisions within the next few months. It is essential that, subject to a careful analysis of public sector specific issues, the IPSASs on financial instruments will be converged as promptly as is practicable with the revised IASB standards. However, given the inevitable lead time between the issue of revised standards and the issue of IPSASs based on them, IPSASB has decided that the issue of standards based on current IFRSs will provide certainty to those currently applying IPSASs (and therefore, by virtue of the hierarchy, current IFRSs). It will also, in IPSASB's view, when taken together with other proposals for convergence, demonstrate the Board's commitment to convergence on a comprehensive basis. IPSASB is therefore proposing to issue these standards as a step towards the objective of comprehensive, up-to-date standards for the public sector rather than as an end in itself. Our comments on the exposure drafts are made in this context.

4. We would emphasise the importance of IPSASB working towards, and to be understood to be working towards, the ultimate objective. It is therefore important that IPSASB continues to monitor developments in IFRS and is willing to adapt its strategy to developments as they arise and does so in a timely manner.

5. One of the consequences of IPSASB's strategy is that fundamental and challenging public sector issues are not addressed in the current exposure drafts. We welcome IPSASB's commitment to deal with these in its future work. As is explained in the Appendix to this letter, we consider that future work will also be required on concessionary loans and financial guarantees (two public sector issues that are addressed in the exposure drafts), although we consider the proposals may be adequate as an interim measure.

6. The Appendix to this letter addresses each of the Specific Matters for Comment raised in the EDs. If you require any further information please contact me or Alan O'Connor (a.oconnor@frc-asb.org.uk) or telephone +44 (0)20 7492 2421).

Yours sincerely



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Specific Matters for Comment

The responses in this Appendix are made in the context of the comments made in the covering letter with regard to IPSASB's convergence strategy.

ED 37 'Presentation'

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.

CAPE Response

We can broadly accept IPSASB's conclusions on financial guarantees and the boundaries between insurance standards and financial instruments standards as an interim measure in the context of IPSASB's convergence strategy.

We are not comfortable with the optionality that exists in the current proposals, particularly for financial guarantees issued by way of an exchange transaction (which may be accounted for either under the financial instruments standards or under the insurance standards). We consider it important that a consistent approach is adopted across public sector entities. We would also highlight the need for further work on the optionality that exists for financial guarantee contracts that involve the transfer of financial risk. The proposals permit, but do not require, these contracts to be accounted for as financial instruments. As part of this work, it may be appropriate to consider contracts that transfer only financial risk.

We agree with the proposal (as explained in paragraph BC 6) that all financial guarantee contracts issued by way of a non-exchange transaction, including those issued at nil or nominal consideration, are to be treated as financial instruments. We also agree with paragraph AG 18 that, in determining whether an arrangement is contractual or non-contractual, an entity needs to consider the substance rather than the legal form of an arrangement (which is why a guarantee issued for no consideration may be within the scope of the standard even if the absence of consideration might make its legal status questionable). As an important drafting point, we note the separation of AG 17 and AG 18 creates the risk that the view may be taken that all arrangements that are non-contractual are outside the scope of the standard by relying on AG 17 to the exclusion of AG 18.

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.

CAPE Response

The proposed transitional arrangements appear to be unnecessarily complicated and, given IPSASB's approach of adopting the IASB standards wholesale, consider that a more straightforward approach could have been adopted. We would also argue that the burden of transition should be minimised because of the expectation that the new standards will be converged, as promptly as is practicable, with the revised IASB standards.

We consider there should be substantial relief on transition, both for entities first adopting the new standards and for entities initially adopting accruals accounting. For example, we consider there should be transitional provisions that avoid the need for entities to review the early years of existing contracts for embedded derivatives, but instead the requirements should be applied on a prospective basis. We also consider that relief should be given from preparing and presenting comparative information.

ED 38 'Recognition and Measurement'

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.

CAPE Response

We agree that, where it is considered that you have a concessionary loan, as defined in the ED, the required accounting is appropriate as an interim measure. We do however consider there is a risk that the true nature of the arrangement is not being captured and that paragraph AG 87 needs to provide more guidance on assessing the substance of a concessionary loan and whether it falls to be classified as a financial instrument.

Where a concessionary loan does fall within the scope of the ED, more guidance on the circumstances in which the subsidy might represent an asset, rather than an expense, of the lender would be useful.

We agree that it is important to distinguish between a concessionary loan and a waiver of debt; the key distinction being that in a concessionary loan the lender agrees to receive a below market rate of return, whereas a waiver of debt arises as a result of a decision to enter into new or revised contractual arrangements for an existing loan.

We consider the illustrative examples for concessionary loans to be helpful. We would however that example 4 would be more helpful if, like example 3, it provided tables explaining the detailed calculations that support the accounting entries.

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.

CAPE Response

We agree that entities should apply a mathematical valuation technique to obtain a fair value where this produces a reliable measure. We also agree that where a fair value cannot be obtained through observation of an active market that initial recognition should be in accordance with IPSAS 19. This approach is considered consistent with the fair value hierarchy that was introduced by the IASB's January 2009 amendment to IFRS 7 and is reflected in ED 39.

We had some difficulty following the fair value hierarchy that is discussed in paragraphs AG95 and AG96. In particular, we do not consider that level two, as described in AG 95, easily reads across to the IASB's level two (on the grounds that level two would normally require market inputs). We therefore suggest that IPSASB more closely aligns its Application Guidance with the IASB text.

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.

CAPE Response

Please see our response to ED 37 on transitional arrangements.

ED 39 'Disclosures'

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?

CAPE Response

We agree with IPSASB's conclusion that there are no public sector specific reasons to depart from the disclosure requirements of IFRS 7.

We would however note the IASB's review of IAS 39 may result in less onerous disclosure requirements being introduced and that these may be appropriate for public sector entities. This is something that IPSASB might consider as it takes forward its work on financial instruments.