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Dear Stephenie

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

The Audit Commission welcomes the opportunity to comment on the discussion paper, “Leases-Preliminary Views”.

The Audit Commission is an independent watchdog, driving economy, efficiency and effectiveness in local public services in England to deliver better outcomes for everyone. We appoint auditors to over 700 major public bodies that are moving to prepare accounts under IFRS. Our work across local government, health, housing, community safety and fire and rescue services means that we have a unique perspective. We promote value for money for taxpayers, auditing the £200 billion spent by 11,000 local public bodies. As a force for improvement, we work in partnership to assess local public services and make practical recommendations for promoting a better quality of life for local people.

The Commission’s Response

We support the continuing progress made by the Board to align IPSASs wherever possible to current IFRSs and ensure that IPSASs contain sufficient guidance on public sector specific issues.

The Exposure Drafts contain guidance on concessionary loans and financial guarantees at nil or nominal consideration and we broadly agree with this guidance subject to detailed comments in the annex to this letter.

We note that the Board acknowledges that further work is required in the future to address other issues in the public sector relating to financial instruments. We support the move to introduce exposure drafts that will substantially align IPSASs to IFRSs with modifications for the key issues in the public sector as an interim measure, but would encourage further work to produce comprehensive standards that covers all public sector specific issues in the near future.

We also note that the Board acknowledges the work currently underway by the IASB to modify IAS39 and would encourage future work to ensure IPSASs are aligned in due course with any revisions to this and other international standards.

Yours sincerely

Stephen Warren
Head of Professional Standards

Annex- Specific Matters for Comment

This Annex contains responses to the specific matters for comment in the Exposure Drafts 37-39.

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.

Response

Whilst we are comfortable with the concept of accounting for financial guarantees issued through an exchange transaction as an insurance contract we do have a number of reservations with the ED as it stands.

(i) We can foresee difficulties with the optionality that exists in the current proposals (para 3.4 c (iii)), as financial guarantees issued by way of an exchange transaction may be accounted for either under the financial instruments standards or under the insurance standards. We believe that comparability between the accounts of public sector entities should be one of the key objectives of any accounting regime and believe that, in its current form, the ED does not meet this objective.

(ii) There is a need for further clarification on the treatment of financial guarantee contracts that involve the transfer of financial risk. The ED currently permits, but does not require, these contracts to be accounted for as financial instruments. This again could lead to a lack of comparability between the accounts of two entities that have identical 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.

Response

We support the proposal not to provide relief for entities initially adopting accruals accounting. No such relief is granted by the source International Accounting Standard (IAS32) and we see no reason why such an exemption should be introduced here. Entities applying accruals accounting for the first time should have to fully review past transactions to identify any transactions covered by this standard and should therefore be able to present 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.

Response

(a) Where an entity has entered into a concessionary loan as defined in the ED, we agree that the required accounting is appropriate. The Application Guidance could better explain the principles contained in the other standards referred to relating to the classification and valuation of the loan.

(b) The distinction between concessionary loans and waiver of debt is an important one and the Application Guidance adequately summarises this distinction.

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.

Response

In the likely event that there is no active market for the type of guarantee entered into, we agree that entities should apply a mathematical valuation technique to obtain a fair value where this produces a reliable measure using other observable inputs. We also agree that where a fair value cannot be obtained from either method that initial recognition should be in accordance with IPSAS 19. This aligns with the with the fair value hierarchy contained in ED 39 (and as contained in the source IASB standard, IFRS 7).

We do not believe that the levels of the fair value hierarchy as explained in AG para 95 adequately reflect the criteria as outlined in ED 39 para 31 and the corresponding Application Guidance. The explanation of Level 2 in AG 95 does not accurately reflect the Level 2 as outlined in ED 39 as it does not stress the importance of inputs from observable sources in the calculation of fair value.

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.

Response

Please see our response to ED 37 on transitional arrangements, above.

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 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?

Response

The Board’s conclusion that there are no public sector specific reasons to depart from the disclosure requirements of IFRS 7 appears valid.