Accounting Standards Board

P O Box 74129
Lynnwood Ridge
0040
Tel. 011 697 0660
Fax. 011 697 0666

Technical Director

International Public Sector Accounting Standards Board

International Federation of Accountants

277 Wellington Street, 4th floor

Toronto, Ontario M5V 3H2

Canada

30 July 2009

Dear Stephenie,

COMMENTS ON ED37, ED38 AND ED39 ON FINANCIAL INSTRUMENTS

We welcome the opportunity to provide comment on the proposed International Public Sector Accounting Standards (IPSASs) on financial instruments. We have consulted our local constituents (comprising professional bodies, auditors and preparers) in formulating our comments to you.

While we support the development of public sector standards on financial instruments, we have reservations about the approach adopted by the IPSASB. These concerns are outlined below, and address both the short and long term strategy of the IPSASB.

While we appreciate that the IPSASB needs to provide urgent guidance to its constituents in the short term, we have reservations about the proposed timing of this project in relation to the IASB's recent proposals to simplify IAS 39. The IASB published proposed simplifications to the classification and measurement of financial instruments in an exposure draft issued on the 14th of July. The IASB intends that these amendments be approved for application by entities with December 2009 year ends, with mandatory adoption tentatively expected by 2012.

If the IPSASB issues its financial instruments standards at its December 2009 meeting, it will coincide to some extent with the issue of the final revisions to IAS 39. If the IPSASB issues its standards, this will mean that entities that apply IPSASs will be required to apply an IPSAS that is more complex than the equivalent private sector standard.

If the IPSASs did not exist, entities would, through use of the hierarchy, be able to use the revised IAS 39 to develop an accounting policy for its financial instruments.

We do not believe that the IPSASB should postpone its project, but propose that a strategy or policy be developed as to how the proposed changes to IAS 39 can be addressed and included in the equivalent IPSASs as soon as possible after their issue by the IASB. As the financial instruments project is a convergence project, the IPSASB could adopt a policy of including final IASB amendments in its standards with minimal amendment and a shortened exposure period. A consultation paper outlining this policy could be issued for public comment and constituents asked for their input prior to this policy being adopted by the IPSASB prior to its December 2009 meeting.

In terms of the IPSASB's longer term strategy on financial instruments, we support the proposal outlined in the basis for conclusions that additional public sector specific issues should be addressed. We would however propose that the IPSASB consider reducing the complexity of the extant requirements of IAS 32, 39 and IFRS 7 for the public sector. IAS 32, 39 and IFRS 7 in their current form may be a barrier to governments and entities adopting IPSASs in the longer term.

Based on our own local circumstances, additional simplification may be appropriate in the following areas:

- Definitions of financial assets and financial liabilities (settlement of transactions in an entity's own equity instruments).
- Puttable instruments and shares in co-operative entities.
- Derecognition of financial assets.
- Treatment of financial guarantees and loan commitments.
- Disclosures.

The remainder of our letter addresses the specific matters outlined in each exposure draft as well as other issues. These are included at Annexure A of this letter.

Please feel free to contact me should you have any queries on our comments.

Yours sincerely

Erna Swart

Chief Executive Officer

ANNEXURE A

ED37 – FINANCIAL INSTRUMENTS: PRESENTATION

1. Specific matter 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.

We do not agree with this approach for the following reasons:

- All financial guarantee contracts are similar in nature, regardless of whether they are issued by way of an exchange or a non-exchange transaction. Consequently, they should all be accounted for in the same way.
- IAS 32 and 39, read in conjunction with IFRS 4, do not allow a free election to either treat a financial guarantee as a financial instrument or an insurance contract. An entity may only use IFRS 4 where the entity has previously asserted that financial guarantee contracts are insurance rather than financial instruments.
- In the absence of a specific IPSAS that deals with insurance contracts, financial guarantee contracts will be accounted for differently by governments and their entities.

Given the significance of financial guarantee contracts in the public sector (particularly in the current economic climate), we propose that the IPSASB treat all financial guarantee contracts as financial instruments. Also see 3.1 below.

If the IPSASB subsequently issues a standard on insurance contracts, consequential amendments, if any, could be made to the relevant financial instruments standards at that stage.

2. Specific matter for comment 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.

While some of our constituents were of the view that relief should be provided from providing comparative information for both ED37, ED38 and ED39, the majority view is that comparative information should be provided, although relief should be considered for certain measurement considerations (see 6 below) and disclosures (consistent with the transitional provisions currently proposed).

Public sector entities have not been provided relief in other IPSASs from presenting comparative information about property, plant and equipment, investment properties, inventories and other tangible assets that are arguably more significant for many entities in the public sector than financial instruments.

We are of the view that without comparative information, the financial statements would be meaningless.

3. Other matters

3.1 Option to treat insurance contracts that transfer financial risk as financial instruments

Paragraph 3 states the following: "….With the exception in (a) and (c) above, an entity may apply this Standard to other financial instruments that take the form of insurance contracts which involve the transfer of financial risk."

In IFRS 4, insurance contracts are defined as: "A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if an uncertain future event adversely affects the policyholder."

It further explains that insurance risk is: "Risk, other than financial risk…"

Financial risks are explained as: "The risk of possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract."

"Insurance contracts" that transfer financial risk meet the definition of a financial instrument even though their legal form may be that of an "insurance contract". We are therefore of the view that such contracts should be accounted for using ED37, ED38 and ED39.

AG7 could clarify that if the distinction between an insurance contract and a financial instrument is uncertain, an entity may elect to either apply ED37, ED38 and ED39 or the international or national accounting standard dealing with financial instruments.

If these amendments are not effected by the Board we propose the following editorial amendment to paragraph 3: "….With the exception in (a) and (c) above, an entity may apply this Standard to other ~~financial instruments~~ contracts that take the form of insurance contracts which involve the transfer of financial risk." It is inappropriate to refer to a permitted application of ED 37 to financial instruments.

3.2 Contractual and non-contractual financial guarantees

While we could not find any examples in local circumstances, it may be useful to include an example of a non-contractual financial guarantee (if such an example exists). If no examples exist, it may be appropriate to amend references to non-contractual financial guarantees in the AG 3 and 4.

ED38 – FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

4. Specific matter 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.

We support the approach adopted in ED38 for the treatment of concessionary loans. AG108 should however be amended to exclude concessionary loans as it relates to the recognition of day 1 gains and losses where initial fair value is determined based on a valuation model using market inputs.

5. Specific matter for comment 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.

We support the proposal as it is a practical means of dealing with the valuation of financial guarantee contracts. We have reservations about the existence of a "price in an active market" for a financial guarantee contract. We also question why loan commitments are treated differently in ED38 even though the overarching accounting principles for both types of instruments are similar.

AG95 refers to a "Level One" and "Level Two" hierarchy. This can be confused with the "Level One", "Level Two" and "Level Three" hierarchy proposed in paragraph 31 of ED39, which has subtle differences. We therefore propose that the references in AG95 be deleted.

6. Specific matter for comment 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.

We agree with the transitional provisions, albeit that they are complex and difficult to understand.

The proposed exposure draft on *Financial Instruments: Classification and Measurement* allow entities the following relief: "If it is impracticable (as defined in IAS 8) for an entity to apply retrospectively the effective interest rate method or the impairment requirements in paragraphs 58-65 and AG84-AG93 of IAS 39, the entity shall determine the amortised cost of the financial instrument or any impairment of a financial asset in each period presented on the basis of the fair value of the financial instrument at the end of each comparative period. If an impairment loss is recognised using that approach or if it is impracticable for the entity to apply the effective interest rate method, the fair value of the financial instrument at the date of initial application shall be the new amortised cost of that instrument at the date of initial application of this [draft] IFRS."

Public sector entities adopting accrual accounting or IPSASs for the first time may find it difficult to determine the effective interest for instruments that were issued several years ago, and may also find it difficult to apply impairment testing retrospectively. We would propose that similar relief be provided in ED38 on the basis of "impracticability" as defined in IPSAS 3.

ED39 – FINANCIAL INSTRUMENTS: DISCLOSURES

6. Specific matter for comment 1

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?

We are of the view that certain disclosures in IFRS 7 could be encouraged rather than required. The following disclosures in particular could be encouraged rather than required:

- The disclosure of fair values for all financial assets and financial liabilities (paragraph 28). It may be extremely costly for entities to determine the fair values of all financial instruments.
- Paragraph 32(b) to (e) outlining various disclosures on the fair value hierarchy. This disclosure may be more relevant for financial institutions than for public sector entities.
- The presentation of a sensitivity analysis (paragraph 46 and 47). Again, this may be useful for a financial institution may be meaningless for public sector institutions unless it is provided in the appropriate context, i.e. what the impact of this would be on service delivery outcomes, tariffs, etc.

GENERAL

ED 37 Financial Instruments: Presentation

7.1 Paragraph 7 – The acronym "GBEs" should be added to the end of paragraph 7 to clarify that this is the meaning of the acronym which is used throughout ED37, ED38 and ED39.

7.2 Paragraphs 44, 45 and AG 17 – The ED deletes the text included in IAS 32 regarding income taxes. However, references to income tax remain in other paragraphs of the application guidance (AG21). This inconsistency should be clarified.

7.3 AG 18 – Consider emphasising that contracts may be verbal or written in this paragraph which discusses the features of contracts.

ED 38 *Financial Instruments: Recognition and Measurement*

7.4 Paragraph 2(f) – Grammar corrections appear to be required in this sentence i.e. *"Any forward contracts that result*~~*s*~~ *from an agreement…"*.

7.5 AG 3 – This paragraph states that the proposed standard would not apply to financial guarantee contracts issued through an exchange transaction which the issuer has previously explicitly asserted are regarded as insurance contracts. However, paragraph 2(e) indicates that where an issuer of a financial guarantee contract has previously explicitly asserted that such contracts are insurance contracts, that issuer <u>has the choice</u> of whether to apply this proposed standard or the international or national insurance contract standard. We propose that this contradiction between the paragraphs be removed.

7.6 AG 87 – This paragraph stipulates that the *"fair value using a valuation technique* ***would be determined****"* using a discounted cash flow model. (Emphasis added) There are many different valuation models in existence, so possibly the restriction to using a discounted cash flow model should be removed. I.e. possibly amend the current word *"would"* to *"could"*.

7.7 AG 91 – The paragraph indicates that non-contractual financial guarantees and financial guarantees where the entity is the holder of the contract are not within the scope of the ED. It is suggested that this paragraph be cross-referenced to those standards which would apply to such transactions.

7.8 Appendix C: C16 – The diagram uses the term "Parent D" rather than 'Controlling Entity D', which is the terminology applied in the narrative discussion in this paragraph. As the diagrams have been updated from IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* to reflect the narrative terminology used throughout this ED, it is suggested that a consistent approach be followed when referring to the parent company / controlling entity D in the diagram.

7.9 Appendix C: C17 – Reference is made to 'Entity B'. Similar to the above-mentioned point with reference to consistency, it is suggested that the ED use the term 'Controlled Entity B'. Similar inconsistencies were identified in paragraphs C18 – C20.

ED 39 Financial Instruments: Disclosures

7.10 Paragraph 3 (c)(iii) – The grammar of the sentence may require rewording as the current reading of the sentence does not appear to make sense. As currently written, the text reads *'However, this Standard applies to an issuer shall apply this Standard to financial guarantee contracts issued through exchange transactions…'*. A suggested rewording is: *'However, this Standard applies to financial guarantee contracts issued through an exchange transaction if the issuer applies IPSAS XX (ED 38)…'*.

7.11 Paragraph 36 details the disclosure required for concessionary loans granted by an entity as well as examples of such loans. It is suggested that there should also be disclosure requirements for concessionary loans received by an entity. It is believed that the following information would be useful to users when considering the concessionary loans received by an entity: nominal value of new loans received in the period; the difference between the fair value of the loan received at initial recognition and the proceeds recognised in terms of IPSAS 23; concessionary loans repaid during the period; interest expense arising from the concessionary loan; nominal value of the loans at the end of the period; terms of the loans received and valuation assumptions.

7.12 Paragraph 50 – There is a grammar error in the sentence. The current word "sector" should be "Sector".

7.13 Paragraph AG5(h) – It is proposed that clarification be made as to whether the disclosure requested relates to the initial or subsequent measurement of financial guarantees issued at no or nominal consideration.