UNITED NATIONS COMMENTS ON

ED 37, ED 38 and ED 39 FINANACIAL INSTRUMENTS: ISSUES IDENTIFIED IN PRELIMINARY ANALYSIS

July 2009

1 The following issues were identified during a preliminary analysis of ED 37, ED 38 and ED 39 Financial Instruments.

Application to assessed contributions receivables

2 When attempting to apply the draft Standards to a United Nations system specific issue – the measurement of an 'assessed contributions receivable' - two areas of uncertainty were identified. The two areas are:

- *Scope*: Extent of application of the scope exclusion applicable to rights and obligations arising from IPSAS 23 (paragraph 2(j) in ED 38).
- *Definitions*: Commentary to distinguish between contractual and non-contractual as applied to the definition of a financial instrument and contributing definitions of financial assets and financial liabilities (paragraph 11 and AG18 in ED 37).

3 Further information, including suggested amendments to improve the Standards and to clarify their application to this specific issue, are provided below.

ED 38: Scope exclusion applicable to IPSAS 23 Revenue from Non-exchange

4 The present wording of the scope exclusion in ED 38 paragraph 2 (j) appears to exclude the application of ED38 to recognition (initial) and to measurement (both initial and subsequent), but the wording is somewhat ambiguous. It is recommended that the scope exclusion in ED 38 paragraph 2 (j) be amended to make its application clearer.

Further comment

5 The word 'initial' is probably intended to apply to both recognition and measurement – consistent with commentary in AG19. If so, then this could be made clearer by including 'initial' in front of 'measurement' as well – see option (1) below. Alternatively, if the intention is to exclude application to all measurement (initial and subsequent), then the exclusion could be clearer by focusing on the rights and obligations rather than their treatment. Three options to clarify the Board's intentions can be identified as follows:

1. **Initial recognition and <u>initial</u> measurement** of rights and obligations arising from non-exchange revenue transactions to which IPSAS 23 applies; or
2. Initial recognition and **measurement (initial <u>and subsequent</u>)** of rights and obligations arising from non-exchange revenue transactions to which IPSAS 23 applies; or
3. **Rights and obligations** arising from non-exchange revenue transactions to which IPSAS 23 applies.

ED 37: Definitions exclude non-contractual

6 The definition of ‘financial instrument’ and the contributing definitions of ‘financial asset’ and ‘financial liability’ are restricted to arrangements that are contractual in nature[1]. This reflects a Board decision to defer consideration of items that arise from non-contractual arrangements, as explained in ED39’s Basis for Conclusions:

> BC2. This project on financial instruments forms part of the IPSASB’s convergence program which aims to converge IPSASs with International Financial Reporting Standards (IFRSs). The IPSASB acknowledges that there are other aspects of financial instruments, insofar as they relate to the public sector, which are not addressed in IAS 39. These will be addressed by future projects of the IPSASB. In particular, the IPSASB acknowledges that future projects are required to address:
>
> - Certain transactions undertaken by central banks; and
> - Receivables and payables that arise from arrangements that are, in substance, similar to, and have the same economic effect as, financial instruments, but are not contractual in nature[2].

7 In terms of explaining the difference between arrangements that are contractual and those that are non-contractual, paragraph 11 (ED 37) states that:

> In this Standard, ‘contract’ and ‘contractual’ refer to an agreement between two or more parties that has **clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law.** Contracts, and thus financial instruments, may take a variety of forms and need not be in writing. [Emphasis added.]

8 Paragraphs AG17 to AG18 provide further guidance as follows:

> AG17 Assets and liabilities in the public sector arise out of both contractual and non-contractual arrangements. Assets and liabilities arising out of non-contractual arrangements do not meet the definition of a financial asset or a financial liability.
>
> AG18. An entity considers the substance rather than the legal form of an arrangement in determining whether it is a ‘contract’ for purposes of this Standard. Contracts, for the purposes of this Standard, are generally evidenced by the following (although this may differ from jurisdiction to jurisdiction):
>
> - Contracts involve willing parties entering into an arrangement;
> - The terms of the contract create rights and obligations for the parties to the contract, and those rights and obligations need not result in equal performance by each party. For example, a donor funding arrangement creates an obligation for the donor to transfer resources to the recipient in terms of the agreement concluded, and establishes the right of the recipient to receive those resources. These types of arrangements may be contractual even though the recipient did not provide equal consideration in return i.e. the arrangement does not result in equal performance by the parties; and.
> - **The remedy for non-performance is enforceable by law.** [Emphasis added.]

[1] See paragraph 9 of ED37, which defines financial instrument, financial asset and financial liability. EDs 38 and 39 use the same definitions. This is stated explicitly in paragraph 9 of ED 38. For clarity, the same statement needs to be included in ED 39.
[2] ED 38 Basis for conclusions, page121. The same wording is included in the Basis for Conclusions of ED 37, see page 57 of ED 38.

9 The shift from 'little if any discretion to avoid' in paragraph 11 to 'remedy…enforceable by law' in AG 18 introduces some uncertainty in applying the distinction. While it seems likely that receivables arising from assessed contributions are not intended to be considered 'contractual,' it is not clear how the present wording in Standard would classify such receivables – contractual or non-contractual. This issue is discussed in more detail below.

Assessed contributions: Contractual or non-contractual?

10 The United Nations and other UN System organizations receive 'assessed contributions' revenue. The question raised by ED 37's explanation of the differences between contractual and non-contractual arrangements is whether or not receivables arising from assessed contributions are contractual in nature.

11 Assessed contributions are 'binding arrangements,' which involve legal obligations for Member States. A Member States' signature on the United Nations Charter involves a commitment to provide funding to the United Nations. That commitment confers a legal obligation under international law. There are consequences for non-payment (loss of voting rights), but international organizations do not attempt to enforce payment through legal channels. Are such arrangements contractual?

12 Applying the criteria in paragraph 11 of ED 37 arguably the answer would be 'no, not contractual,' because international organizations do not pursue payment through legal channels. Similarly applying the criteria in paragraph AG18 of ED 37 the answer appears likely to be 'no, not contractual' because the remedy for non-performance is not enforceable by law. But the consequences of non-performance are serious enough to ensure that most Member States most of the time will pay their outstanding assessments. In the United Nations case a Member State can lose its right to vote in the General Assembly.

13 Despite the lack of certainty when attempting to apply the draft Standard's words to this specific issue, our view is that receivables from assessed contributions are an example of a non-contractual arrangement. To clarify AG 18 and the application of these draft Standards to assessed contributions receivables, the following change to AG18's wording is recommended (change under-lined). It is further recommended that other examples of 'non-contractual' arrangements be included in the application guidance in order to better explain this critical distinction.

Recommended change to AG 18

> AG18. An entity considers the substance rather than the legal form of an arrangement in determining whether it is a 'contract' for purposes of this Standard. Contracts, for the purposes of this Standard, are generally evidenced by the following (although this may differ from jurisdiction to jurisdiction):
>
> - Contracts involve willing parties entering into an arrangement;
> - The terms of the contract create rights and obligations for the parties to the contract, and those rights and obligations need not result in equal performance by each party [delete narrative and include below]; and.
> - The remedy for non-performance is enforceable by law.

Equal performance not required: Commercial contracts ordinarily create rights and obligations that result in equal performance by each party. This will not necessarily be the case for public sector contracts. For example, a donor funding arrangement creates an obligation for the donor to transfer resources to the recipient in terms of the agreement concluded, and establishes the right of the recipient to receive those resources. These types of arrangements may be contractual even though the recipient did not provide equal consideration in return i.e. the arrangement does not result in equal performance by the parties.

Examples of non-contractual arrangements: Examples of non-contractual arrangements include: Member States obligations under international treaties to provide assessed contributions funding to international organizations; [other examples]

Summary table

14 Table 1 in Appendix 2 provides an overview of the two areas of uncertainty described above and shows how they impact on the draft Standards' implications for rights and obligations arising from IPSAS 23, illustrating with three specific examples of non-exchange transactions.

APPENDIX 2: TABLE 1 DEFINITION AND SCOPE APPLIED TO IPSAS 23 RIGHTS AND OBLIGATIONS

Rights and obligations arising from:	**Definition of financial instruments – must involve a contract**	**Scope exclusion – Initial recognition**	**Scope exclusion – Initial measurement**	**Scope exclusion – Subsequent measurement**
1. IPSAS 23	Clear: Some within definition and some not	Excluded	Excluded	Unclear – probably included (Recommend clarify paragraph 2(j))
1(a) Taxation	Excluded from definition (non-contractual)	Not applicable (already excluded by the definition of financial instruments)	Not applicable (already excluded by the definition of financial instruments)	Not applicable (already excluded by the definition of financial instruments)
1(b) Funding agreements (Voluntary contributions)	Not excluded from definition (contractual)	Excluded	Excluded	Unclear – probably included (Recommend clarify paragraph 2(j))
1(c) International treaty (Assessed contributions)	Unclear: Probably excluded from definition Recommend: Clarify by providing as an example in AG18	Excluded	Excluded	Unclear (Probably excluded on the basis that the arrangement is not contractual)