The OPEC Fund
for International Development (OFID)

Technical Director
International Public Sector Accounting Standards Board (IPSASB)
International Federation of Accountants (IFAC)
277 Wellington Street, 4th Floor
Toronto, Ontario M5V CANADA

COMMENTS ON EXPOSURE DRAFT (ED) No. 38: *FINANCIAL INSTRUMENTS RECOGNITION AND MEASUREMENT*

Thank you for making ED 38 available for public comments.

Our main focus in this paper is the accounting treatment of concessionary loans. OFID is a Multilateral Financial Institution (MFI) established to foster social and economic advancement in the developing world through concessional financing and grants.

We agree with your distinction between concessionary loans and waiver of debt.

However, we do not agree with the proposal in the Application Guidance to expense the difference between the transaction price and fair value of concessionary loan at initial recognition. We discuss the basis of our objection in the paragraphs below.

Consistency with accounting principles

ED 38 paragraph BC8 states: "the issuer of a concessionary loan accounts for the off-market portion of the loan as an expense in the year the loan is issued."

To qualify for recognition in the income statement, an expense[1]:

1. should arise from one or more of the following:
   1.1. outflows relating to an entity's ongoing or central operation e.g. wages

[1] The criteria for expense recognition are widely discussed in accounting literature. See for example IPSAS No. 1, Presentation of financial statements paragraph 7; FASB, Statement of Accounting Concepts No. 6 paragraphs 80-81; IASB Framework for the preparation and presentation of financial statements, paragraphs 94-98; UK ASB Statement of principles for financial reporting paragraphs 4.39-4.40;

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1.2. depletion of assets e.g. depreciation of fixed assets

1.3. incurrence of liability other than those relating to acquisition of assets and distribution to equity holders e.g. warranties and accruals;

1.4. losses e.g. loss of facilities as a result of earthquake

2. should result in a decrease in the entity's equity; and

3. should be capable of being reliably measured

The proposed accounting treatment of imputed interest expense does not satisfy criteria 1.1-1.4 listed above.

As shown in the table below which is based on ED 38 Example 4, net income over the loan period is $76.5 million whether the nominal or effective interest rate method is applied i.e. imputed interest has no impact on the entity's equity. Thus, criterion No. 2 above is equally not satisfied.

ED 38 EAMPLE 4: IE 40-42				
	Loan		Loan Interest Revenue	
Year	Repayment	Balance	Nominal	Effective
	CU	CU	CU	CU
0	-	250,000,000	-	(50,654,520)
1	-	250,000,000	15,000,000	22,924,730
2	-	250,000,000	15,000,000	23,836,074
3	-	250,000,000	15,000,000	24,852,223
4	75,000,000	175,000,000	15,000,000	25,985,228
5	75,000,000	100,000,000	10,500,000	18,623,530
6	100,000,000	-	6,000,000	10,932,735
	250,000,000		76,500,000	76,500,000

The analysis in the above table further reveals lack of comparability in financial statements (Year 0 and other years) as a result of inconsistent measurement basis (fair value in year 0 and amortised cost in other years). Although AG89 leaves open the choice of basis for measurement subsequent to initial recognition, the examples (e.g. IE40-42) in fact endorse the amortised cost measurement (the amount of $50,654,520 expensed in Year 0 is recognised as revenue over years 1 to 5).

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Determination of "market interest rate"

ED 38 defines the fair value of a concessionary loan as the present value of future contractual payments discounted using the market related interest rate. Typically, the market interest rate is the basic or risk-free rate plus a margin which reflects the credit rating of the borrower [ED 38 AG 114 (a)(b)].

In the advanced and some emerging economies of the world where capital market is well developed, the estimation of market interest rate is relatively straightforward. However, for entities in developing countries and the financial institutions lending to them at concessionary rates, attempts to estimate market interest rates often involve too many assumptions[2] such that two independent persons cannot arrive at the same conclusion, therefore rendering the exercise highly subjective, the result unreliable and the financial statements incomparable across years and with those of other institutions.

The effect of this is the reluctance of many public sector organisations to adopt the fair value standard to their concessionary loans. In this group are MFIs which are specialised institutions lending at below-market or nil interest rates to governments, mainly in developing nations.

At OFID, our attempt to implement IAS 39 on our public sector (concessionary) loans revealed the onerous nature of the exercise and raises questions about its benefit in relation to cost apart from the other issues already identified above. Most MFIs agree that their public sector loans are not intended for sale as there is no comparable secondary market for such loans. A review of the annual reports of African Development Bank (AfDB),[3] Asian Development Bank (ADB)[4] and the World Bank International Development Association (IDA)[5] among others will also indicate reasons why many public sector institutions may not be willing to recognise their concessionary loans at fair value.

[2] These include assumptions about credit rating where the borrower is not rated and the determination of credit spread for different ratings including speculative investment rating
[3] AfDB, 2007 Annual Report p.231
[4] ADB, 2006 Annual Report p79
[5] World Bank IDA, Financial Statements for the year ended 30 June 2008 p33

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Convergence issues

In this age of globalisation, convergence of accounting standards is imperative for entities with similar operating and reporting objectives. We therefore commend your effort in pursuing this goal.

We note that the exposure draft is drawn primarily from International Accounting Standard (IAS) 39. While IASB standards are designed for the private sector and government business entities, IPSAB standards are designed for public sector entities. The objectives of profit and not-for-profit entities are not necessarily the same.

Since ED 38 is drawn primarily from IAS 39, it may also have inherited some of its weaknesses which are currently being addressed by the International Accounting Standards Board (IASB). You may be aware that IASB is in the process of fully revamping IAS 39 following wide criticisms and recommendations by the G20 forum. Also, in May 2009, IASB released an exposure draft on *Fair Value Measurement* with comments expected to be received by 28 September 2009. These will have some implications on ED 38 particularly in the classification and reclassification of financial instruments (ED 38 paragraphs 47-48, 53-63) and impairment recognition (ED 38 paragraphs 67-80).

The current thinking is that financial instruments should be categorised into those at:

(a) Amortised cost i.e. loans and those instruments having the features of loan; and
(b) Fair value i.e. other instruments not at amortised cost.

Also, the current thinking on impairment is in favour of the expected loss model as opposed to the incurred loss model in ED 38.

Conclusion

In our opinion, imputed expenses generally and imputed interest specifically should not be recognised in financial statements. However, public sector entities should determine where practicable and disclose the extent of subsidy on their concessionary loans in a note to their

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financial statements. The disclosure should include all assumptions made by an entity in arriving at the amount of subsidy.

If you need any further clarifications on the matters raised above, please feel free to contact the undersigned.

Yours faithfully,

Taiwo Olalere
Acting Controller
Financial Operations Department

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Tel: +43-1-515 64-0 • Fax: +43-1-513 92 38 • E-mail: info@ofid.org • www.ofid.org