

Basis for conclusions

This basis for conclusions gives the Accounting Standards Board's (the Board's) reasons for accepting or rejecting certain proposals related to the accounting for financial instruments. This basis for conclusions accompanies, but is not part of, this Standard.

Introduction

Approach adopted by the Board

- BC1. This Standard prescribes the recognition, measurement, presentation and disclosure principles for financial instruments. This Standard is drawn primarily from pronouncements issued by the International Accounting Standards Board (IASB). These pronouncements include:
- IAS Standard on *Financial Instruments: Presentation* (IAS 32);
 - IAS Standard on *Financial Instruments: Recognition and Measurement* (IAS 39);
 - IFRS Standard on *Financial Instruments: Disclosures* (IFRS 7); and
 - IFRS for SMEs[®] Accounting Standard.
- BC2. The Board also considered the pronouncements and practices of other countries as part of the development process. The Board will consider the impact of any IFRIC[®] Interpretations as part of a separate project.
- BC3. The Board's key strategy in developing this Standard was to use the relevant IFRS Accounting Standards as a basis, and to simplify and streamline the principles prescribed in those Standards wherever appropriate. In order to achieve this, the Board undertook to:
- eliminate alternative accounting treatments for similar transactions, where possible; and
 - eliminate guidance on transactions that are not commonly found in the public sector.
- BC4. This basis for conclusions summarises the significant departures that are made from IFRS Accounting Standards and the reasons for such departures.

Future developments

- BC5. Although the IASB recently announced its intention to revise and simplify certain aspects of IAS 39 during 2009, the Board agreed that it would not wait for the IASB to finalise its revisions to IAS 39 before issuing the statement since the issue of this Standard is a Board priority. The Board did, however, agree to undertake a review of this Standard once the IASB has completed its project. In particular, the Board wishes to identify other areas of this Standard which are based on IAS 39 and IFRS 7 and which could be simplified, e.g. the accounting for embedded derivatives and the elimination of certain disclosures when the review takes place.

Scope

Elimination of guidance on transactions not commonly found in the public sector

BC6. One of the most significant differences between the IFRS Accounting Standards and this Standard is the scope. IFRS Accounting Standards provide guidance on:

- loan commitments;
- certain share-based payment transactions, including the presentation of treasury shares;
- contingent settlement provisions; and
- settlement options.

BC7. Based on stakeholder consultations, the Board concluded that some of these transactions are not commonly undertaken in the public sector and, as a result, no guidance has been provided in this Standard for these transactions. Where such transactions exist, particularly those outlined below, an entity applies the Standard of GRAP on *Accounting Policies, Changes in Accounting Estimates and Errors* in formulating an appropriate accounting policy:

- treasury shares; and
- contracts that will or may be settled in an entity's own equity instruments and are:
 - (i) non-derivatives for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - (ii) derivatives that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Loan commitments

BC8. Certain commitments to provide loans under pre-specified conditions are within the scope of IAS 39, while others are within the scope of the IAS Standard on *Provisions, Contingent Liabilities and Contingent Assets*. As entities may enter into loan commitments in the public sector, the Board considered including certain loan commitments, particularly those that provide a loan at a below-market interest rate, within the scope of this Standard.

BC9. In terms of IAS 39, entities initially measure loan commitments at fair value which is equal to the commitment fee charged. Entities in the public sector that enter into commitments to provide loans at a below market interest rate usually don't charge a commitment fee. It is difficult to determine a reliable fair value for commitments where no fee is charged. As a result, the Board concluded that it would not include the recognition and measurement of loan commitments within the scope of this

Standard, but would instead require entities to account for all loan commitments as follows:

- any obligation arising from loan commitments should be recognised, measured and/or disclosed in accordance with GRAP 19;
- where a commitment fee is charged, the fee should be accounted for in accordance with GRAP 9; and
- loan commitments should however be derecognised and disclosed in accordance with this Standard.

BC10. The Board concluded that where a commitment fee is charged, an entity shall consider this in determining the best estimate of any obligation that arises from issuing the loan commitment. An entity shall recognise any obligation arising from a loan commitment at the higher of:

- (a) the amount determined in accordance with GRAP 19; and
- (b) the amount of the fee initially recognised less, where appropriate, cumulative amortisation recognised in accordance with GRAP 9.

Financial guarantee contracts

BC11. Under IAS 39, entities are allowed in certain instances to account for financial guarantee contracts as either financial instruments or as insurance contracts in terms of the IFRS Accounting Standard(s) on insurance. As the Board does not intend issuing an IFRS Accounting Standard(s) on insurance equivalent for general use by all entities, it concluded that only entities (insurers) that are primarily engaged in insurance activities may account for financial guarantees in accordance with the IFRS Accounting Standard(s) on insurance, while other entities should account for financial guarantees in accordance with paragraphs BC12. to BC16.

BC12. IAS 39 requires the issuer of financial guarantee contracts to initially measure them at fair value. The fair value on initial recognition would be the guarantee fee charged by the entity (assuming the fee is market related). The Board considered requiring financial guarantee contracts to be initially measured at fair value in accordance with the requirements of IAS 39, but concluded that there may be public sector reasons to deviate from IAS 39.

BC13. A deviation from IAS 39 is appropriate because the reasons for issuing financial guarantees in the public sector are different to the private sector. In particular, financial guarantees may be issued in the public sector to:

- ensure certain projects are initiated and that they are affordable, e.g. an entity may guarantee the debt of a private sector entity in a public-private partnership arrangement;

- stabilise and assist certain areas of the economy, e.g. the provision of guarantees to lenders on behalf of industries or businesses during times of economic hardship;
- assist entities in raising affordable financing, e.g. by guaranteeing their bond issues; and
- provide certain services which are in the public interest, e.g. guaranteeing the deposits of certain financial institutions or providing guarantees on behalf of participants in a social housing scheme.

BC14. As financial guarantee contracts are often issued in the public sector without a guarantee fee being charged, entities would be required to determine a fair value for financial guarantee contracts by way of valuation if the approach under IAS 39 is followed. Given the nature and extent of the financial guarantees issued in the public sector, the Board concluded that initial measurement at fair value is not feasible because the cost of obtaining these valuations would outweigh the benefits for users of the financial statements. It also concluded that given the nature of the guarantees provided, a valuation technique may not necessarily provide a reliable measure of fair value.

BC15. Consequently, the Board concluded that:

- any obligations arising from financial guarantees should be initially recognised, measured and/or disclosed in accordance with GRAP 19;
- any fee received by the issuer of financial guarantee contracts should be accounted for in accordance with GRAP 9; and
- financial guarantees should be derecognised and disclosed in accordance with this Standard.

BC16. The Board concluded that where a guarantee fee is charged, an entity should consider this in determining the best estimate of any obligation that arises from issuing the guarantee. An entity should therefore recognise any obligation arising from a financial guarantee at the higher of:

- (a) the amount determined in accordance with GRAP 19; and
- (b) the amount of the fee initially recognised less, where appropriate, cumulative amortisation recognised in accordance with GRAP 9.

Rights and obligations arising from non-exchange revenue transactions

BC17. Following the principles of GRAP 23 entities may recognise monetary assets and liabilities, such as receivables and payables, as a result of a non-exchange revenue transaction. While GRAP 23 provides guidance on the initial recognition and measurement of such transactions, it does not provide any guidance on the subsequent measurement, derecognition, presentation and disclosure of such receivables and payables.

BC18. To the extent that these receivables and payables arise out of contractual arrangements and otherwise satisfy the definition of a financial asset or a financial liability, this Standard should be used for the subsequent measurement, presentation and disclosure of such instruments.

BC19. Financial instruments that are within the scope of this Standard can only arise out of contractual arrangements. As a result, any monetary financial assets and monetary financial liabilities that arise from non-contractual, non-exchange revenue transactions are not within the scope of this Standard. The subsequent measurement, derecognition, presentation and disclosure of these non-contractual monetary assets and monetary liabilities will be prescribed in a Guideline to be issued by the Board.

Hedge accounting

BC20. Similar to the Board's decision of not providing guidance on certain financial instruments, it has concluded that only a limited number of entities apply hedge accounting in the public sector. Entities may apply hedge accounting, as long as they comply with the requirements of IAS 39 on hedge accounting as well as the disclosures in IFRS 7.

Definitions

Residual interest

BC21. The IASB defines a financial instrument as: "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity", with an equity instrument being defined as, "any contract that shows evidence of a residual interest in the net assets of an entity after deducting all of its liabilities".

BC22. The use of the term "equity instruments" in the public sector is limiting since entities most often do not have capital that is comprised of shares or other forms of unitised capital. Capital contributions in the public sector may be evident in a number of ways, for example, by a formal agreement between the parties to the transaction or a designation of a transfer of resources that represents an interest in the net assets of an entity.

BC23. Consequently, the Board agreed to replace "equity instruments" with a term that was more representative of the various types of contributed capital found in the public sector. As a result, the term "equity instruments" has been replaced with "residual interest".

BC24. The definition of "residual interest" describes a residual interest as representing an interest in the net assets of an entity, and that the interest may be evident in:

- equity instruments, for those entities where their contributed capital comprises share capital;

- an agreement between parties that a transfer of resources between entities represents a residual interest in the net assets of an entity; and
- a designation of a transfer of resources between entities that establishes a residual interest in the net assets of another entity.

Financial assets and financial liabilities

BC25. The IASB's definition of a financial asset and a financial liability deals with the settlement of financial instruments in an entity's own equity instruments. It is not common for entities in the public sector to have contributed capital that comprises equity instruments. In cases where the contributed capital comprises equity instruments, there are usually restrictions placed on the ownership of such instruments. It is therefore unlikely that entities will use equity instruments to settle any financial instruments, and thus these requirements have not been included in the definition of a financial asset and a financial liability for purposes of this Standard.

BC26. To the extent that these transactions are undertaken, entities should apply the relevant IFRS Accounting Standards (see paragraph BC7.).

Categories of financial assets and financial liabilities

BC27. Subsequent measurement of financial assets and financial liabilities in IAS 39 is based on the categorisation of such assets and liabilities into defined categories. The categories defined in IAS 39 are as follows:

Financial assets

1. financial assets at fair value through profit or loss;
2. held-to-maturity investments;
3. loans and receivables; and
4. available-for-sale financial assets.

Financial liabilities

1. financial liabilities at fair value through profit or loss; and
2. financial liabilities at amortised cost.

BC28. The categorisation of financial instruments into the various categories in IAS 39 is overly complex for the types of instruments used in the South African public sector. The Board concluded that streamlining the number of categories and simplifying the classification of financial instruments would be appropriate for the types of transactions most commonly undertaken in the public sector. As a result, the Board agreed to prescribe only three categories of financial instruments:

- financial instruments at fair value, with the changes in fair value recognised in surplus or deficit;

- financial instruments at amortised cost; and
- financial instruments at cost.

BC29. In formulating the three categories of financial instruments, the Board examined existing guidance from the following sources:

- existing categories in IAS 39, particularly the financial assets and financial liabilities at fair value and loans and receivables category;
- SMEs Standard; and
- proposed guidance issued by the Public Sector Accounting Standards Board of the Canadian Institute of Chartered Accountants.

BC30. Based on the categories of financial instruments included in IAS 39 and the SMEs Standard, it identified three measurement bases commonly used for financial instruments, i.e. fair value, amortised cost and, in limited instances, cost.

BC31. In defining the categories of financial instruments, the Board considered whether fair value should be used as a single measurement basis for all financial instruments. It concluded that measuring all financial instruments at fair value may be inappropriate for the following reasons:

- the objective of most public sector entities is to deliver essential public services. The acquisition or incurrence of financial instruments is often as a consequence of their service delivery actions. Entities often do not manage financial instruments on a fair value basis and an alternative measurement basis should thus be allowed;
- the cost of determining fair values for all financial instruments may outweigh the benefits of providing such information; and
- measuring certain financial liabilities at fair value may result in an understatement of an entity's liabilities at reporting date.

BC32. The Board therefore considered that both fair value and amortised cost should be used as measurement bases for financial instruments. It sought to identify what the appropriate criteria should be for measuring financial instruments at fair value and amortised cost respectively.

BC33. The Board concluded that derivative financial instruments and instruments held for trading should be measured at fair value since this best reflects the entity's intention for holding such instruments.

BC34. It concluded that non-derivative instruments with fixed or determinable payments, such as deposits with financial institutions, debtors, creditors and other debt instruments should be measured at amortised cost. The Board noted, however, that in certain instances measuring non-derivative instruments with fixed or determinable payments at amortised cost may be inappropriate and may not reflect an entity's

intention for holding a specific instrument. A specific example may occur where an entity undertakes economic hedging by entering into a derivative to offset fluctuations in a non-derivative debt instrument, with the effect that the derivative is measured at fair value and the debt instrument at amortised cost.

- BC35. As a result, the Board concluded that entities should be allowed to designate non-derivative financial instruments with fixed or determinable payments at fair value on initial recognition, on an instrument by instrument basis. The Board considered the circumstances under which designations at fair value may be appropriate. It concluded that a free designation of non-derivative financial assets with fixed or determinable payments at fair value should be allowed, although the criteria for the designation of such financial assets at fair value should be provided in an entity's accounting policies. It concluded that non-derivative financial liabilities with fixed or determinable payments should only be designated at fair value to eliminate a recognition or measurement inconsistency that would otherwise arise from applying the principles of this Standard to financial assets and financial liabilities.
- BC36. The Board also acknowledged that it may be appropriate to designate certain combined instruments, which would otherwise require separation in accordance with this Standard, at fair value. It concluded that combined instruments, which include a host contract that is a financial instrument, could be designated at fair value in certain instances.
- BC37. The Board also concluded that the use of cost as a measurement basis for financial instruments should be limited. It agreed to limit the use of fair value to those investments in residual interests where fair value cannot be reliably measured.

Regular way purchases and sales of financial assets

- BC38. IAS 39 allows regular way purchases and sales of financial assets to be recognised using either trade or settlement date accounting. A distinction is necessary in IAS 39 between regular way purchases and sales of financial assets and other purchases and sales of financial assets, such as derivatives, because derivatives are recognised on their trade date only. In order to eliminate alternative accounting treatments as far as possible for similar transactions, the Board concluded that it would only prescribe that trade date accounting be used for regular way purchases and sales of financial assets. The decision to eliminate settlement date account is based on practice in the public sector internationally and locally.
- BC39. As trade date accounting is effectively prescribed for all purchases and sales of financial assets, the Board deemed it unnecessary to make a distinction between regular way purchases and sales of financial assets and purchases and sales of other financial assets. As a result, the concept of regular way purchases and sales of financial assets had been omitted from this Standard.

Concessionary loans

- BC40. Concessionary loans are either received or granted by government or its entities for a variety of social or economic reasons. These loans usually have lenient repayment terms and are granted at below market interest rates.
- BC41. IAS 39 provides guidance on the accounting treatment for low or no interest loans. It prescribes that these loans should be measured on initial recognition at fair value. This is equal to the present value of the contractual cash flows, discounted using a market related rate of interest for a similar transaction. The difference between the proceeds of the loan and the present value of the contractual cash flows is amortised over the period of the loan using the effective interest method.
- BC42. The Board concluded that in the case of concessionary loans, the difference between the present value of the contractual payments using a market related rate of interest for a similar debt instrument, with similar terms, maturity, currency and risk profile and the proceeds granted or received, may, in substance, result in non-exchange revenue (for the recipient of a concessionary loan), or a social benefit (for the grantor of a concessionary loan).

Accounting treatment by the recipient

- BC43. The Board considered that where an entity receives a concessionary loan, the difference between the loan proceeds and the fair value of the loan may result in either non-exchange revenue or a contribution from owners.
- BC44. The Board concluded that entities should consider the guidance in this Standard as well as GRAP 23 in identifying whether the difference between the fair value of the loan and the loan proceeds is a transfer of resources that is non-exchange revenue or a contribution from owners.

Accounting treatment by the issuer

- BC45. The Board agreed that the issuer of a concessionary loan should also assess whether the nature of the difference between the loan proceeds and the fair value of the loan represents an additional capital contribution or a transfer of resources. The Board concluded that the issuer of a concessionary loan should apply this Standard as well as the *Framework for the Preparation and Presentation of Financial Statements*² in making this assessment.
- BC46. A transfer might be provided in the form of a social benefit. Social benefits are defined for purposes of this Standard, as a cash transfer paid to individuals and households in a non-exchange transaction to protect them against certain social risks. Where an entity grants concessionary loans to individuals or households, a component of the concessionary loan may be deemed to be a social benefit and accounted for in accordance with the *Framework for the Preparation and Presentation of Financial Statements*².

² In June 2017, the Board replaced the *Framework for the Preparation and Presentation of Financial Statements* with the *Conceptual Framework for General Purpose Financial Reporting*.

BC47. Where entity grants a concessionary loan to another entity (which for purposes of this Standard would include, but not be limited to, an unincorporated entity, partnership or trust) the difference between the loan proceeds and the fair value of the loan is treated in accordance with the *Framework for the Preparation and Presentation of Financial Statements*².

Discounting financial assets and financial liabilities on initial recognition

BC48. IAS 39 requires that financial assets and financial liabilities initially be recognised at fair value. Appendix A paragraph AG79. states that, “Short term receivables and payables with no stated interest rate may be measured at the original amount if the effect of discounting is immaterial”.

BC49. Determining when discounting is or is not material has been an area of interpretation that has resulted in divergent practice in the public sector. The effect of discounting can be material from the day that services are received or provided if a period of credit is received by or granted to consumers of those goods and services. However, to discount receivables or payables at this point may be onerous and impractical in the public sector.

BC50. As a result, the Board has concluded that financial assets and financial liabilities should not be discounted prior to their due date for payment, unless the credit period granted is not in line with operating terms in the public sector. Where the credit granted between the date of originating the receivable or payable and its due date for payment is not in line with accepted practice or legislation in the public sector, an entity shall consider whether the effect of discounting is material.

Reclassifications of financial instruments

BC51. As the Board prescribed categories of financial assets and financial liabilities for purposes of subsequent measurement that are different from IAS 39, the circumstances under which reclassifications may be made differ from IAS 39. The paragraphs that follow outline under what circumstances reclassifications may be made.

BC52. As the categories of financial instruments are more flexible than under IAS 39, the Board considered that reclassifications between the various categories of financial instruments should be limited. It concluded that reclassifications should not be allowed while instruments are issued or held, except in the following cases:

- (a) A host contract that is part of a combined instrument may be reclassified from amortised cost or cost to fair value if it was separated from the embedded derivative on initial recognition, and the fair value of the embedded derivative cannot be measured reliably at a subsequent reporting date. This effectively requires a reclassification of the host contract from amortised cost or cost to fair value during the life of the debt instrument.

- (b) An investment in a residual interest may be reclassified between the fair value and cost categories. If fair value cannot be measured reliably for an investment in a residual interest, an entity may measure it at cost. Similarly, if a fair value can be measured reliably for the investment, it should be measured at fair value.

No other reclassifications are permitted.

BC53. The Board considered whether reclassifications should be allowed from fair value to amortised cost where fair value can no longer be determined for instruments measured at fair value or because there has been a change in management's intention.

BC54. An entity is allowed a certain degree of flexibility at initial recognition to measure certain instruments at amortised cost or fair value. The Board therefore concluded that in order to simplify the requirements of this Standard and to avoid the manipulation of an entity's results, the accounting for financial instruments should be based on management's intention and actions at initial recognition.

Derecognition of financial assets

BC55. The principles for derecognising financial assets in IAS 39 are too complex for most of the transactions undertaken by public sector entities. As a result, the Board agreed to follow a simpler approach by adopting the principles in the SMEs Standard for derecognising financial assets. This approach does not require entities to:

- test whether the contractual rights to receive the cash flows of a financial asset have been retained by the entity, but with a corresponding obligation to pay those cash flows to one or more entities (called "pass-through" testing); and
- apply a continuing involvement approach. This approach is applied where entities retain control of an asset, but transfer some risks and rewards of ownership of a financial asset to one or more entities.

BC56. In the absence of applying a continuing involvement approach, this Standard requires that entities continue to recognise financial assets in their entirety, with the exception of specifically identified cash flows of financial assets, such as interest strips, that may result in the derecognition of part of a financial asset.

Presentation

BC57. IAS 32 requires entities to recognise gains and losses on financial instruments either in a statement of comprehensive income or in a separate income statement. As the Board has not yet considered the amendments made by the IASB to the IAS Standard on *Presentation of Financial Statements* (IAS 1), which introduced a statement of comprehensive income in the financial statements, this Standard only allows entities to recognise such gains and losses in the statement of financial performance.

Disclosure

- BC58. Disclosures have been modified from IFRS 7 to accommodate the new categories of financial instruments introduced in this Standard.
- BC59. IFRS 7 requires extensive disclosures about the credit risk related to loans and receivables designated at fair value. The Board is of the view that these disclosures are not relevant to the types of financial instruments that commonly occur in the South African public sector. As a result, these disclosures have not been included in this Standard.
- BC60. IFRS 7 requires that the fair value of all financial instruments be disclosed in the financial statements. The Board is of the view that providing the fair values for all financial instruments may be costly. As a result it concluded that disclosure of the fair value of financial instruments is encouraged, but not required. The Board has also only encouraged rather than required entities to produce information about transfers between the various levels in the fair value hierarchy, reconciliations of the opening and closing balances of various levels within the fair value hierarchy and sensitivity analyses of the various assumptions used within the various levels of the fair value hierarchy.
- BC61. In line with paragraph BC60., the Board has also not prescribed the disclosure of the fair value of any collateral held by the entity. The Board has, however, prescribed that entities disclose whether or not, in management's view, the collateral held is sufficient for the debt owing to the entity.
- BC62. IFRS 7 requires entities to prepare a sensitivity analysis, outlining the impact of market risks on profit or loss or equity. Many entities in the public sector are not exposed to significant market risks because, for example, legislation limits entering into transactions in foreign currency and other complex financial instruments. As a result the Board concluded that a sensitivity analysis should be encouraged for those entities where this information would be useful.
- BC63. The Board received input from stakeholders indicating that disclosure of the nominal values of instruments may be particularly useful for accountability purposes because officials in the public sector are held accountable for the nominal values of financial assets and financial liabilities and not their fair values. In particular, it is useful to disclose the nominal values of financial assets and financial liabilities where the transaction price is not representative of fair value on initial recognition. The Board agreed that it should be mandatory for entities to disclose the nominal values of concessionary loans granted or received and that entities should be encouraged to provide the nominal values of other financial assets or financial liabilities where this information is useful to users of the financial statements.
- BC64. The IASB amended IAS 1 in 2005, requiring entities to disclose additional information about how they managed their capital. The purpose of these disclosures is to highlight important factors for users to consider in assessing the risk profile of an entity and its ability to withstand unexpected adverse events, including how those changes may affect the entity's ability to pay dividends.



GRAP 104

BC65. Many entities in the public sector do not hold contributed capital and may not borrow money. As a result, entities do not focus on managing their capital as envisaged by the IAS 1 disclosures. As a result, the Board deemed these disclosures to be inappropriate to the South African public sector and has not proposed similar amendments to GRAP 1.