

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 in its development and revision of GRAP 104

Initial development

- BC1. GRAP 104 prescribes the recognition, measurement, presentation and disclosure principles for financial instruments. This Standard was 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 Accounting Standard on *Financial Instruments: Disclosures* (IFRS 7); and
 - IFRS for SMEs[®] Accounting Standard (SMEs Accounting Standard).
- BC2. The Board also considered the pronouncements and practices of other countries as part of the development process.
- BC3. The Board's key strategy in developing GRAP 104 was to use the relevant IFRS Accounting Standards as a basis, and to simplify and streamline the principles prescribed in those Standards wherever appropriate. As a result, the Board eliminated:
- alternative accounting treatments for similar transactions, where possible; and
 - guidance on transactions that are not commonly found in the public sector.

Revision of GRAP 104

- BC4. The IASB replaced IAS 39 with the IFRS Accounting Standard on *Financial Instruments* (IFRS 9) in 2014. IFRS 9 substantially revised the way in which financial instruments are classified, how amortised cost is determined, how and when financial assets are assessed for impairment, and overhauled the requirements for hedge accounting.
- BC5. The Board received feedback from its stakeholders during the consultation on the work programme that certain aspects of GRAP 104 should be revisited in the light of IFRS 9 being issued. Stakeholders requested that the Board reconsider the categories of financial instruments (financial assets in particular), the impairment model, and hedge accounting.

- BC6. In reviewing the three areas identified by stakeholders, the Board considered whether, or the extent to which, GRAP 104 should be aligned with IFRS 9. The Board agreed that it is important to maintain alignment with IFRS 9 as far as possible, but that due consideration should be given to (a) whether the principles are suitable for the public sector; and (b) simplification wherever possible.
- BC7. Where relevant, the Board also considered:
- any revisions to IAS 32 and IFRS 7; and
 - guidance in IPSAS 29 on *Financial Instruments: Recognition and Measurement* as well as IPSAS 41 on *Financial Instruments*.
- BC8. The Board issued an Exposure Draft of the *Proposed Revision of the Standard of GRAP on Financial Instruments* (ED 167) in May 2018.

Scope

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

- BC9. IFRS Accounting Standards provide guidance on:
- (a) certain share-based payment transactions, including the presentation of treasury shares;
 - (b) contingent settlement provisions; and
 - (c) settlement options.
- BC10. Based on stakeholder consultations, the Board concluded that some of these transactions are not commonly undertaken in the public sector and, as a result, guidance on these transactions has been eliminated. Where such transactions exist, particularly those outlined below, an entity applies GRAP 3 in formulating an appropriate accounting policy:
- (a) settlement options;
 - (b) treasury shares; and
 - (c) contracts, including puttable instruments, 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

- BC11. When the Board originally issued GRAP 104, it agreed that loan commitments, i.e. a firm commitment to provide loans under pre-specified conditions, should be excluded from the recognition and measurement requirements of this Standard. Although the Board concluded that loan commitments may be prevalent in the public sector, it may be difficult to initially determine a fair value for such instruments as entities are unlikely to charge a commitment fee. The Board agreed that loan commitments should be recognised and measured using GRAP 19.
- BC12. In terms of IFRS 9, only some loan commitments are within its scope, most notably loan commitments to provide a loan on below market terms. All loan commitments are however subject to the impairment and derecognition requirements of IFRS 9. IFRS 9 requires that entities initially measure loan commitments at fair value, and subsequently at the higher of fair value, less any revenue recognised, and the loss allowance. In terms of the new impairment model in IFRS 9, when an entity assesses whether a loan is impaired, it considers both the drawn and undrawn portion of the facility, which includes any loan commitment. As a result of this change in approach, the Board agreed that it could no longer allow entities to recognise loan commitments using GRAP 19, as the accounting approach in GRAP 19 is incompatible with the impairment requirements of IFRS 9. As a result, the Board agreed that the accounting for loan commitments should be revised and aligned with IFRS 9.

Measurement of loan commitments in a non-exchange transaction

- BC13. When the Board initially developed GRAP 104, one of the concerns raised was the initial measurement of a loan commitment where no fee is charged. The same concern was expressed for the initial measurement of financial guarantee contracts. In reconsidering the accounting for financial guarantee contracts (see paragraphs BC19. to BC28.), the Board agreed that in the absence of a fee being charged, a valuation technique should be used to measure fair value. If this did not result in a reliable measure of fair value, then the financial guarantee contract should be measured at the loss allowance. The Board agreed that a similar approach should be applied for loan commitments.

Measurement of a loan commitment to provide a concessionary loan

- BC14. As the measurement of commitments to provide loans at below market terms is in the scope of this Standard, the Board considered the potential impact for concessionary loans. As a first step, the Board considered whether "loans at below market terms" are, or include, concessionary loans. The Board agreed that loans "at below market terms"

is wider than just concessionary loans. Loans granted on below market terms include commercial arrangements that are concluded on unfavourable terms relative to the market, and also include concessionary loans which are made deliberately to achieve government's specific policies. Secondly, the Board considered how commitments to provide concessionary loans should be measured as paragraph 5.4 indicates that such loans should be accounted for by separating the loan element from any concessionary element.

- BC15. In determining how commitments to provide concessionary loans should be measured, the Board considered what information would be relevant to users. When an entity commits to provide a loan on concessionary terms, it is effectively committing to an outflow of resources on terms that are unfavourable to an entity. Having information about the value to be given away when, as well as the expected credit losses, it commits to the loan, provides relevant information to users of the financial statements about (a) the level of resources needed to fund the loan and the concessionary (social benefit) component, and (b) the credit risk exposure when entering into the arrangement.
- BC16. The Board agreed that the initial measurement of the loan commitment should include both the expected loss allowance and the concessionary (social benefit) component of the loan, and that both these aspects should be recognised using the *Framework for the Preparation and Presentation of Financial Statements*².
- BC17. The Board considered the following aspects related to the measurement of a commitment to provide concessionary loans:
- (a) Whether initial recognition on the basis outlined in paragraph BC16. affects the subsequent measurement of the loss allowance. The Board agreed that there will be no effect, but that entities will need to keep record of the initial loss allowance recognised to avoid double counting when subsequently measuring credit losses on the loan commitment. Entities will need to ensure that they only measure and recognise any changes in the loss allowance initially recognised.
 - (b) Whether any additional guidance is needed in the situations when a loan commitment is issued, but subsequently expires and is not utilised. It was agreed that the requirements for derecognising financial liabilities should be applied and the effect recognised in the statement of financial performance.
- BC18. Respondents to ED 167 supported the Board's proposals for loan commitments.

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*.

Financial guarantee contracts

General principle

BC19. Financial guarantee contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with terms of a debt instrument. Financial guarantee contracts, although often only issued by a limited number of entities in the public sector, can be significant in value. While the issuing of financial guarantee contracts is commonplace in the private sector, the reasons for issuing financial guarantees differ between the public and private sector. In the private sector, it is often a financial institution that issues financial guarantees in return for a fee. In the public sector, financial guarantees may be issued 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.

BC20. IAS 39 required entities to initially measure financial guarantee contracts at fair value. As financial guarantee contracts are often issued in the public sector without a guarantee fee being charged, entities were required to determine a fair value for financial guarantee contracts by way of valuation. 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. In its initial development of GRAP 104, the Board agreed that GRAP 19 should be applied to account for financial guarantee contracts.

BC21. In revising GRAP 104, the Board reconsidered whether this approach provides users of the financial statements with the most relevant information to hold entities accountable and make decisions. The Board observed that, by applying GRAP 19, liabilities related to financial guarantee contracts would only be recognised when an outflow of economic benefits or service potential is probable. Until this threshold is reached, financial

guarantee contracts would be disclosed as contingent liabilities. The issuing of a financial guarantee contract has an economic consequence for the issuer which should be considered by users in the context of managing debt and exposure to credit risk. As a result, the Board believed that the approach to recognising and measuring financial guarantee contracts needed to be revised.

- BC22. IFRS 9 requires an entity to initially recognise financial guarantee contracts at their fair value, and subsequently at the higher or the fair value (which is usually the fee charged for issuing the guarantee) less any revenue recognised, and the loss allowance which reflects the entity's expected credit losses over the contract period. The Board agreed that this initial measurement at fair value reflects the fact that a potential liability is assumed by the issuer, and the subsequent measure reflects the need to assess and measure the entity's exposure to credit risk at each reporting date. The subsequent measurement based on the expected credit losses on the contract reflects an entity's credit risk exposure to the counterparty whose debt is guaranteed. Based on these arguments, the Board agreed that, in principle, financial guarantee contracts should be in the scope of the revised GRAP 104 and accounted for using the principles in IFRS 9.
- BC23. Although there was broad agreement that the principles in IFRS 9 provide more relevant information to users, the same concerns were raised by preparers during the initial development of GRAP 104 about the initial measurement of financial guarantee contracts issued in a non-exchange transaction, i.e. where no, or only a nominal, fee is charged.
- BC24. As a result of the concerns raised, the Board considered whether fair value should be determined for all financial guarantee contracts or only those issued in exchange transactions. The Board agreed that fair value should be determined for all financial guarantee contracts as the economic consequences of the transaction are the same. The Board noted that since initially issuing GRAP 104, guidance has been developed by the IPSASB on how to measure the fair value of financial guarantee contracts issued in non-exchange transactions. This guidance will assist in overcoming many of the issues initially raised. The Board agreed that if a reliable measure of fair value cannot be determined by an entity, then an entity initially measures the financial guarantee contract at the value of the loss allowance. A reliable measure of fair value may not be available if, for example, the range of fair values determined by the entity is significant, and/or the range of reasonable estimates cannot be assessed.
- BC25. IFRS 9 allows entities to treat financial guarantee contracts as insurance contracts where a past, explicit assertion has been made by an entity that it deems these contracts to be insurance contracts. As financial guarantee contracts were previously recognised and measured using GRAP 19, entities were not permitted to previously

treat these contracts as insurance contracts. As a result, the Board eliminated this alternative accounting treatment.

The government as the “lender of last resort”

BC26. The government often acts as the “lender of last resort”, usually to protect key activities, functions or assets within the economy. The government’s obligations as the lender of last resort most often arise from specific legislative requirements to intervene, for example, when certain entities are in distress, to fund shortfalls on pension or similar funds, etc. Questions were raised during the revision of GRAP 104 about whether government’s role as the lender of last resort meets the definition of a financial guarantee contract. The Board agreed that these types of arrangements do not meet the definition of a financial guarantee contract (a) because these obligations are statutory rather than contractual in nature, and (b) there is no specific lending arrangement in place as there is no borrower, lender or specific debt being guaranteed.

Letters of support

BC27. Respondents to ED 167 questioned whether letters of support would meet the definition of a financial guarantee contract. Letters of support are typically provided by a controlling entity to a controlled entity outlining the provision of financial support. The letters of support vary from providing general financial support (e.g. standing in for any shortfall in budget, revenue etc.), indicating that specific expenses will be paid (e.g. employee’s salaries and other benefits), and in some cases, guaranteeing debt that the controlled entity may hold.

BC28. The Board agreed that the terms of the conditions of the arrangement would need to be examined to understand whether the letter of support meets the definition of a financial guarantee contract, i.e. that the arrangement is contractual, and that a specific debt arrangement is guaranteed. Promises of continued financial support, or the payment of operational expenses, do not meet the definition of a financial guarantee contract. If the controlling entity promises to guarantee the debt of the controlled entity but there is no debt held by the controlled entity, then the letter of support would also not meet the definition of a financial guarantee contract. The letter of support is a possible obligation of the controlling entity and should be accounted for using GRAP 19. A financial guarantee would only be recognised once a specific debt arrangement is entered into by the entity.

Rights and obligations arising from non-exchange revenue transactions

BC29. 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.

- BC30. To the extent that the receivables and payables recognised in accordance with GRAP 23 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.
- BC31. Financial instruments that are within the scope of this Standard can only arise from 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 are in the scope of GRAP 108.

Hedge accounting

- BC32. Based on feedback received from stakeholders during the development of GRAP 104, the Board agreed that there is no need to provide guidance on hedge accounting. This is because of the legislative environment which prohibits entities from entering into certain types of instruments, and as a result, limits the hedging instruments available to entities. Entities were however permitted to apply hedge accounting using the principles in IAS 39.
- BC33. In revising GRAP 104, the Board revisited its earlier decision and again assessed whether there is a need for guidance on hedge accounting. A limited number of entities indicated that they applied hedge accounting. Based on this experience, the Board reconfirmed that no guidance is needed in a revised GRAP 104. Entities are however permitted to apply the hedge accounting requirements in IFRS 9, or the requirements in IAS 39 until such time as they are withdrawn by the IASB. Respondents to ED 167 supported the Board's proposals because entities seldom enter in hedging transactions, and if they do, they are not concerned about offsetting the gains and losses.
- BC34. Some respondents questioned whether the lack of hedge accounting requirements meant that entities could no longer undertake economic hedging. The Board agreed that economic hedging (subject to the specific legal requirements for individual entities) is not affected by the inclusion or exclusion of requirements for hedge accounting.

Definitions

Residual interest

- BC35. 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”.
- BC36. 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.
- BC37. 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”.
- BC38. 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

- BC39. 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 been not been included in the definition of a financial asset and a financial liability for purposes of this Standard.
- BC40. To the extent that these transactions are undertaken, entities should apply the relevant IFRS Accounting Standards (see paragraph BC10.).

Classification of financial instruments

Overarching classification principles

- BC41. The classification principles introduced by IFRS 9 are principle based and focus on the underlying characteristics of an instrument as well as the reasons for an entity holding a financial instrument. This is a significant change from IAS 39 which was largely rules based, and was one of the reasons why the Board developed its own categories of financial instruments based on the principles in IAS 39 and the SMEs Accounting Standard.
- BC42. The Board agreed with the overarching classification, and reclassification, principles in IFRS 9 and agreed to align GRAP 104 as far as possible. The Board agreed to depart from the classification principles in IFRS 9 in the following areas, with the reasons discussed below:
- (a) Elimination of the category of financial assets “at fair value through other comprehensive income”.
 - (b) Retention of the category of financial assets “at cost”.

Financial assets at fair value through other comprehensive income

- BC43. In IFRS 9, an entity that has a strategy of holding financial assets to collect cash flows and for sale, and the cash flows of the asset are “solely payments of principal and interest” (SPPI), classifies such assets at fair value through other comprehensive income. Although the type of instruments included in this category are similar to those measured at amortised cost, the reason for holding the instruments is different. In the amortised cost category, although sales are permitted, they are incidental rather than being integral to the entity’s strategy. Given the nature of public sector entities’ operations, the Board considered whether the fair value through other comprehensive income category should be introduced.
- BC44. The Board observed that entities do not frequently have a strategy of both holding and actively selling instruments. As a result, the Board agreed that such a category is likely not needed. The Board observed that the use of comprehensive income is a mechanism used in the private sector to remove volatility from the statement of financial performance. This results in some gains and losses being presented in the statement of financial performance, while the gains and losses that relate to changes in the market (for the most part) are recognised in the statement of other comprehensive income. The Board agreed that having some gains and losses recognised in the statement of financial performance and some in the statement of other comprehensive income does not provide meaningful information to users and may make it hard for users to assess performance. The Board also agreed that the public sector is often less

concerned with volatility in the statement of financial performance as this is not an entity's primary metric of performance.

- BC45. The Board agreed to not introduce the category of financial assets at fair value through other comprehensive income for the reasons outlined in paragraph BC44. The Board agreed that if an entity does not meet the requirements to measure financial assets at amortised cost, such instruments are measured at fair value through surplus or deficit. Respondents to ED 167 supported the Board's approach.

Financial assets at cost

- BC46. In IAS 39, an entity was permitted to measure investments in residual interests (equity instruments) at cost if there was no reliable measure of fair value. As public sector entities frequently invest in entities with unlisted equity or capital, the Board adopted this principle when GRAP 104 was developed. In IFRS 9, the IASB has limited the use of cost by indicating that it can only be used when more recent information about the investment is unavailable and outlines a number of situations when a fair value must be determined, e.g. where there has been a change in the performance on the entity in which the investment is held. The Board debated whether, in revising GRAP 104, entities should be permitted to continue to use cost.
- BC47. In discussing the merits of retaining this approach, the Board noted that when public sector entities invest in the residual interests of other entities, it is usually for public policy reasons. The entities are often newly established, start-up entities and undertake activities to promote economic growth, employment or innovation in certain industries. As a consequence, determining fair value is difficult as there is no market for the instruments, and data for an equivalent instrument or entity is also unlikely to be available. This means that the valuations are likely to be complex and require a high degree of estimation. As a result, it is likely that experts will be needed.
- BC48. The Board considered whether using cost, while practical, provides useful information to users of the financial statements. If such investments are made to achieve particular policy objectives, the Board questioned whether recognising an investment at all provides meaningful information to users. On balance, the Board agreed that cost represents the entity's or public sector's investment of economic benefits or service potential in a particular entity and that investment should be recognised.
- BC49. The Board agreed that, as a practical expedient, entities should be allowed to measure investments in residual interests at cost where a reliable measure of fair value is unavailable. The Board emphasised the following:
- The use of cost is not an accounting policy choice and that entities may only use cost after demonstrating that there is no reliable measure of fair value.

- The assessment of whether a reliable measure of fair value is available is not a once off assessment. Entities need to determine on an ongoing basis if a reliable measure of fair value is available. If a reliable measure of fair value becomes available (or vice versa), an entity reclassifies the instrument. As such the definition of “reclassification date” and the related principles have been modified from IFRS 9 to accommodate the measurement of the instrument at cost.

- BC50. While many respondents to ED 167 supported the use of cost as a practical expedient, some expressed concern that the practical expedient may be misused. These respondents suggested either (a) limiting the use of fair value to those investments where there is a significant “service potential” component, and/or (b) adding disclosure to the notes to the financial statements indicating why fair value could not be determined, including what specific inputs could not be determined.
- BC51. The Board agreed that it may be onerous and subjective to determine whether an investment is made for its service potential, but agreed that entities should disclose why fair value could not be measured reliably.
- BC52. Many of the respondents who indicated support for retaining the use of cost as a practical expedient noted their challenges with determining the fair value of unquoted equity instruments. They also noted that they often use external valuers to value these instruments, and that the valuers use a range of techniques to determine fair value. The acceptability of these techniques was questioned. The Board agreed to add examples to the implementation guidance outlining some of the techniques that could be used to determine fair value. These examples were drawn from the International Public Sector Accounting Standard on *Financial Instruments* issued by the IPSASB.

Effect of classification principles on concessionary loans granted by an entity

- BC53. The Board noted that the subsequent measurement of some concessionary loans under the new classification principles could potentially change. Under the previous classification principles in GRAP 104, all concessionary loans were measured at amortised cost less impairment. The Board observed that some concessionary loans, particularly those that are not solely payments of principal and interest, would need to be measured at fair value. These would typically include loans that have contingent repayment features, or have features that are not linked to a basic lending arrangement, e.g. repayment when a specific income or profitability threshold is reached, when certain metrics are achieved, finding employment etc. While the Board noted the change in measurement, it believed that measurement at fair value better reflect the features and economic characteristics of the loan.
- BC54. Some respondents to ED 167 did not support the measurement of concessionary loans at fair value. They noted that the users of the financial statements are likely to be interested in the value of the loans granted, the subsidy component and the amounts

repaid. Users are unlikely to be interested in the exposure to market risk at each reporting date, as the types of entities that provide concessionary loans do not actively manage the market risk associated with the loans.

- BC55. Other respondents supported the measurement of concessionary loans at fair value as the measurement basis to be applied reflected the economic characteristics of the cash flows of the loan. They were of the view that fair value faithfully represents the economic substance of a loan that is exposed to risks outside of a basic lending arrangement. They also noted that it may be difficult to determine the amortised cost of some loans, particularly those with contingent repayment features. They observed that determining the expected credit loss on these loans would be onerous. These respondents also did not believe that a rule should be created for classifying specific types of transaction, and that it would be difficult to adequately define a concessionary loan in a way that did not create accounting arbitrage.
- BC56. The Board agreed to retain the approach proposed in ED 167 on the basis that it did not want to introduce rules in an otherwise principle based Standard. They also noted the concerns with determining the amortised cost of instruments with cash flows that do not vary according to basic lending risks.

Initial recognition

Regular way purchases and sales of financial assets

- BC57. 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 at 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.
- BC58. 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.
- BC59. The principle in IFRS 9 is unchanged, and in the interest of simplifying this Standard by eliminating alternative accounting treatments, the Board confirmed its earlier decision. Respondents to ED 167 supported the Board's position.

Initial measurement

Concessionary loans

- BC60. 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 for interest, capital or both, and/or are granted at below market interest rates.
- BC61. 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 represented 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 was amortised over the period of the loan using the effective interest method (by applying an effective interest rate).
- BC62. 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).
- BC63. With the alignment of GRAP 104 with the impairment requirements of IFRS 9, a number of principles related to the measurement of concessionary loans issued by an entity needed to be revisited. In particular, the Board considered the implications for the measurement of concessionary loans that are credit-impaired on purchase or origination and those that become credit-impaired after initial recognition.
- BC64. The existing guidance in GRAP 104 requires an entity to separate a concessionary loan into two components: (a) the loan (financial asset) and (b) the concessionary (social benefit element of the loan). Any impairment losses were considered separately as part of the subsequent measurement of the loan. IFRS 9 introduces a requirement to assess whether a financial asset is credit-impaired on purchase or origination. An entity is required to include any expected credit losses in the fair value of the loan on initial recognition. The inclusion of expected credit losses in the initial measurement not only affects the cash flows used to determine fair value, it also affects the interest rate used to discount the cash flows (this rate is the credit-adjusted effective interest rate). For concessionary loans that become credit-impaired, the treatment under IFRS 9 and GRAP 104 on initial recognition is unchanged.
- BC65. The Board believes that having separate information on the concessionary (social benefit) component of the loan and the credit loss is important, as it helps users to identify what resources were given away by the entity to achieve particular government

policies, and what resources are being lost as a result of poor credit management practices or exposure to credit risk. While this can be achieved for concessionary loans that become credit-impaired after initial recognition, it is not possible to separately distinguish the concessionary (social benefit) component of the loan from the expected credit losses for loans that are credit-impaired on purchase or origination without modifying the principles in IFRS 9. As a result, the Board agreed that the concessionary element recognised should include the credit losses and any social benefits provided. The Board however introduced a requirement to disclose the nominal values of the loans along with the nominal values of the social benefit and credit loss components in the notes to the financial statements.

- BC66. Stakeholders also raised potential issues with determining the fair value of a purchased or originated credit-impaired concessionary loan on initial recognition. It is unlikely that a market, or reliable market data, exists on which to determine fair value. As a practical expedient when a reliable measure of fair value cannot be determined for purchased or originated credit-impaired concessionary loans, stakeholders suggested measuring fair value by reference to:
- The estimated cash flows of the instrument, including expected credit losses. The expected cash flows reflect the cash flows that are expected from the instrument, rather than what the entity collects, or is willing to collect, i.e. the entity's own collection practices are ignored in determining the expected cash flows.
 - Discounted using a rate that best reflects the time value of money of the instrument. This rate should exclude any consideration of credit risk as the effect of credit risk is included in the expected cash flows.
- BC67. The Board agreed that this approach may provide more meaningful information to users under the circumstances, as the measurement appropriately reflects the credit risk of the instrument and considers the settlement of the instrument over time.
- BC68. Respondents to ED 167 supported the proposed accounting treatment of credit-impaired concessionary loans, but they did not support the disclosure of the nominal values of the cash flows of the loans along with the social benefit and credit loss components. Respondents indicated that this would be onerous, and that the availability of the information would depend on the valuation technique applied. The Board agreed to delete this disclosure requirement.

Accounting treatment by the recipient

- BC69. 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.

- BC70. 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

- BC71. 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 a loan 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.
- BC72. 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.
- BC73. Where an 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.

Concessionary investments

- BC74. In revising IPSAS 29, the IPSASB discussed the notion of a “concessionary investment”. This is when an entity invests in the residual interests of another entity, usually to achieve specific public policy objectives, and all or part of the investment is a non-exchange transaction. The Board agreed that guidance on how to account for these transactions may be useful and would ensure that transactions are accounted for based on their underlying economic characteristics. The principles underlying the accounting treatment of these instruments are the same as concessionary loans. As the entity would need to assess whether the transaction is an investment in another entity or a social benefit, the Board noted that the terms and conditions of the arrangement between the parties would need to be examined to identify the component parts. If it is unclear from the arrangement whether there is one or more part to the transaction, the default treatment is that the investment is treated as the acquisition of an interest in the residual interests of the entity.

BC75. Respondents to ED 167 supported the inclusion of this guidance in the Standard as a reminder that these investments should be analysed to determine their nature. It was however noted that substance over form should be applied rather than relying solely on the terms and conditions of the arrangement. As the application of substance over form is consistent with the *Framework for the Preparation and Presentation of Financial Statements*², the Board agreed to modify the application guidance accordingly.

Fair value

BC76. The concept of fair value in IFRS 9 is based on that outlined in the IFRS Accounting Standard on *Fair Value Measurement* (IFRS 13). As there is no equivalent of IFRS 13 in the public sector, the Board agreed to retain the existing fair value guidance from IAS 39.

Discounting financial assets and financial liabilities on initial recognition

BC77. Appendix A paragraph AG5.8 indicates 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”. 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.

BC78. As a result, the Board 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.

Subsequent measurement

BC79. After the global financial crisis, the IASB substantially changed its approach to both assessing when an asset is impaired, as well as how the amount of any potential impairment loss is calculated. This has meant a complete change to the impairment model included in GRAP 104, as well as how amortised cost and interest revenue are determined. The Board agreed that it should align the impairment approach and method for determining amortised cost in GRAP 104 with that in IFRS 9. A number of principles were however considered in deciding whether the approach in IFRS 9 results in relevant information for users of financial statements in the public sector. The paragraphs that follow outline the key areas of the Board’s deliberations. Respondents to ED 167 were broadly supportive of the proposals and noted issues requiring

additional implementation guidance rather than disagreeing with the overarching principles.

Amortised cost

BC80. With the change in impairment approach, there have been a number of changes to the way in which amortised cost of a financial asset is determined, as well as how interest revenue is calculated. In particular, interest revenue is calculated by applying the effective interest rate to the gross carrying amount of the financial asset, unless it is credit-impaired on purchase or origination, or becomes credit-impaired. In these instances, interest revenue is based on the amortised cost of the instrument (i.e. including the allowance) and using the credit-adjusted effective interest rate for purchased or originated credit-impaired instruments. The Board's discussion on the appropriateness of these principles for the public sector is outlined in paragraphs BC81. to BC96. below.

Write offs

BC81. IFRS 9 introduced the notion of a “write-off” of financial assets where there is no reasonable expectation that part of a financial asset is collectable. While stakeholders supported the principle, they requested guidance on the interaction between write-offs and the loss allowance under the new impairment model. In particular, guidance was requested on whether write-offs should first be recognised in the loss allowance, or whether any write off is recognised by removing any balance in the loss allowance and recognising any additional amount in the statement of financial performance.

BC82. The Board debated whether it should provide explicit guidance on the approach to be followed. The Board acknowledged that under the new expected credit loss approach, entities are likely to anticipate any significant declines in credit risk and include these in the loss allowance at year end. It is however possible that unforeseen circumstances arise which mean that a further loss should be recognised. For these reasons, and given that entities in the public sector undertake diverse activities, the Board agreed that entities can apply either approach outlined in BC67.

Impairment of financial assets

BC83. The IASB substantially changed the impairment approach from an “incurred loss model” in IAS 39 to an “expected credit loss model” in IFRS 9. The approach in IFRS 9 means that users have information available earlier about any anticipated credit losses on financial assets. Given the potential for improved information to users, the Board agreed to align the impairment approach in GRAP 104 with that in IFRS 9 as far as possible. The exceptions are discussed below.

Purchased or originated credit-impaired financial assets

- BC84. In terms of the new expected credit loss model, an entity includes expected credit losses over the life of a financial asset in the initial measurement of an instrument that is credit-impaired on purchase or origination. The effective interest rate – called the “credit-adjusted effective interest rate” – is used to calculate interest revenue using the value of the financial asset including credit losses.
- BC85. The Board noted that entities in the South African environment are often required to transact with other parties to provide basic services, irrespective of whether those parties can afford to pay for the services received. This means that there is a high prevalence of revenue transactions where their collectability is in doubt at the initiation of the transaction. The potential implications of introducing the requirements for purchased or originated credit-impaired transactions can therefore have a pervasive effect on the sector, and in particular, local government.
- BC86. Given the potential implications, the Board considered the effect of including credit losses in the initial measurement in the receivable on the recognition of revenue related to the sale of goods and services, and in particular, whether this principle is consistent with IGRAP1 *Applying the Probability Test on Initial Recognition of Revenue*. The recognition of interest revenue on a “net” rather than a “gross” basis was also considered.
- BC87. In considering the requirements for purchased or originated credit-impaired financial assets in IFRS 9 to sale transactions, the Board concluded that a reduced amount of revenue would be recognised, as the receivable would be measured including any expected credit losses. The Board concluded that this is inconsistent with IGRAP 1 which views uncollectability (i.e. credit losses) as an event that is considered in the subsequent measurement of the transaction.
- BC88. As a result of the inconsistency between IFRS 9 and IGRAP 1, the Board debated whether it should amend the requirements of IGRAP 1 or IFRS 9. The Board agreed that the principles in IGRAP 1 respond directly to the legislative obligations of public sector entities locally to collect, and be accountable for, all revenue due to the state. As a result, the Board agreed that the principles for purchased or originated credit-impaired instruments should not be applied to receivables related to contractual revenue arrangements in the scope of GRAP 9 or GRAP 23. The Board noted that while it supports a departure from IFRS 9, it is to respond to the legislative environment locally rather than being a disagreement with the conceptual merits of the principle.
- BC89. With regards to the recognition of interest revenue, the Board noted that IGRAP 1 makes no explicit reference to interest revenue. Given that interest revenue is calculated on a net basis (i.e. including credit losses) for purchased or originated credit-impaired instruments, or when an instrument becomes impaired after initial recognition,

the Board agreed to exclude the recognition of interest from IGRAP 1. Without this amendment, situations may arise when entities will recognise interest on a gross rather than a net basis by applying the principles in IGRAP 1, while ignoring the specific prescripts of GRAP 104.

Recognition of interest on receivables that become credit-impaired

- BC90. The principles in ED 167 require the recognition of revenue on a net basis, i.e. using the amortised cost of a financial asset, when the instrument becomes credit-impaired after origination. Respondents indicated that from a practical perspective, this requirement would mean that entities would need to have systems that can calculate interest using more than one basis, and the system would need to be able to track when the credit-impaired status of a financial asset changes. Respondents indicated that these additional requirements would not be catered for in either their debtors' sub-ledger or general ledger. These calculations would need to be done outside the system using, for example, a spreadsheet. As many municipalities and public entities have large debtors' books, undertaking these calculations outside the general ledger system is costly, onerous, and subject to a high degree of risk. Respondents also questioned what informational value would be gained by using a net basis of determining revenue as using the gross basis has the same net effect.
- BC91. The Board agreed with the conceptual arguments for recognising revenue on a net basis when a financial asset is credit-impaired and that interest revenue and impairment losses should not be overstated. The Board however acknowledged the cost and effort that would be required to implement this requirement, along with the associated risk of error. The Board agreed that, because the net effect is the same and weighing cost-benefit considerations, interest revenue on receivables should only be recognised using the gross basis.

Financial assets measured at cost

- BC92. The Board considered whether the expected credit loss model could be applied to financial assets measured at cost. The Board considered that the expected credit loss model may be inappropriate for such investments as the model requires sophisticated information about credit risk and expected cash flows (based on historical, current and forecast data) which may not be available for the instruments in question. The Board debated whether it should retain the existing impairment approach in GRAP 104 for these instruments. The existing approach relies on a loss event occurring, rather than focusing on expected losses. An entity could estimate the expected cash flows of the instrument after this event and discount them based on a market rate at reporting date.
- BC93. The Board debated whether it is appropriate to continue to measure an investment at cost if cash flow information is available. Arguably if cash flow information is available, then the instrument should be measured at fair value. The Board agreed that the

threshold to use fair value as a measurement basis is higher than the threshold to use cash flows for impairment purposes. The Board also agreed that if an event has occurred that indicates that the value of the investment has declined, then the entity has no alternative but to assess impairment using the best information available. Based on these arguments, the Board agreed to retain the current impairment model in GRAP 104 for investments in residual interests measured at cost. An entity should use the definition of a “credit-impaired financial asset” to assess whether a loss event has occurred.

Simplified approach for impairing receivables and lease receivables

- BC94. In assessing the period over which expected credit losses should be determined, an entity determines whether there has been a significant increase in credit risk. A significant increase in credit risk requires an entity to use lifetime expected credit losses. Where there has been no significant increase in credit risk, an entity estimates losses over a twelve month period. In IFRS 9, an entity can use a practical expedient for trade and lease receivables where there is no significant financing transaction. The practical expedient allows entities to use the lifetime expected credit losses of the instrument. Entities have a choice of applying this expedient where there is a significant financing transaction, and may apply the choice separately for trade and lease receivables. This Standard uses the term “receivables”, which broadly refers to contractual arrangements where goods and services are provided by the entity to another party.
- BC95. As the practical expedient means that entities do not need data about credit risk, this is helpful in the public sector environment where entities are often compelled to transact with other parties, and as a result, do not collect information on the credit risk of their customers. The Board agreed that, in the interest of simplifying the requirements, the lifetime expected credit losses should be determined for all trade and lease receivables, irrespective of whether a financial transaction exists.

Use of collateral in determining expected credit losses

- BC96. In determining the expected credit losses of an instrument, an entity considers the effect of any collateral held. In developing GRAP 104, the Board agreed that collateral should not be considered by an entity in estimating credit losses if the entity has no intention to use the collateral. This is particularly the case where municipalities hold collateral over fixed property for any amounts owing to it, but in most instances, the municipality does not utilise the collateral if this would create undue hardship on the other party. The Board agreed that this principle should be retained and applied under the expected credit loss approach.

Recognition of gains and losses

BC97. IFRS 9 allows entities an irrevocable choice on initial recognition to recognise the fair value gains and losses on investments in residual interests in other comprehensive income. For the same reasons outlined in paragraph BC44., the Board agreed that this accounting policy choice should not be permitted. All fair value gains and losses on investments in residual interests should be recognised in surplus or deficit.

Derecognition of financial assets

BC98. When the Board originally issued GRAP 104, the principles for derecognising financial assets in IAS 39 were deemed to be 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 Accounting 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.

BC99. 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 be result in the derecognition of part of a financial asset.

BC100. The derecognition requirements in IFRS 9 are the same as in IAS 39. In revising GRAP 104, stakeholders did not raise any specific issues with the derecognition requirements, and as a result, they were retained, unamended.

Presentation

BC101. 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.

BC102. New criteria were introduced to explain the offsetting of financial instruments as part of the revisions to GRAP 104. Respondents to ED 167 supported the criteria but indicated

that the legal right of set-off may be difficult to achieve given the insolvency and other laws in South Africa.

Disclosure

BC103. In developing GRAP 104, the Board aimed to streamline and simplify the disclosure requirements wherever possible so that relevant information is provided to users of the financial statements. In revising GRAP 104 to align it with the revised requirements of IFRS 7 following the issue of IFRS 9, the same approach was followed.

Disclosure of credit risk information for assets and liabilities measured at fair value

BC104. IFRS 7 requires extensive disclosures about the credit risk of financial assets and financial liabilities designated at fair value. The Board was initially of the view that these disclosures are not relevant to the types of financial instruments that commonly occur in the South African public sector. The Board however noted that users of the financial statements need this information to assess the proportion of changes in fair value that are due to a change in market or credit risk. As a result, the Board agreed to re-instate these disclosure requirements. The Board also agreed that, because some concessionary loans could now be measured at fair value rather than amortised cost, the disclosures should be extended to concessionary loans granted by an entity.

Disclosing the fair value of instruments measured at amortised cost

BC105. 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.

BC106. 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.

BC107. The Board asked respondents to ED 167 whether they believed this disclosure was relevant to users. Mixed views were expressed by respondents. Some indicated that the information is relevant, while others indicated that the disclosure may not be relevant as an entity could have both secured and unsecured lending. On balance, the Board agreed that the holding of collateral affects the measurement of the instrument, and that an entity need not always hold collateral for debts owing to it. The disclosure requirement was deleted as a result.

Disclosure of the nominal values of instruments

BC108. The Board received input from stakeholders during the initial development of GRAP 104 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.

BC109. In revising GRAP 104, the Board reconsidered the encouraged disclosure of nominal values. In line with decisions on other projects, the Board agreed that it should eliminate encouraged disclosures wherever possible as a means of simplifying the requirements of the Standards of GRAP. As a result, the Board agreed to delete this disclosure.

Exposure to market risk

BC110. 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 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 is only required to be prepared by an entity when it is exposed to significant market risk.

Management of contributed capital

BC111. 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.

BC112. 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.