

Exposure Draft: Financial Instruments

This is an overview of the Exposure Draft (ED) 62, *Financial Instruments*.

Project objectives:

This Exposure Draft (ED) proposes new requirements for classifying, recognizing and measuring financial instruments to replace those in IPSAS 29, *Financial Instruments: Recognition and Measurement*.

Development of ED 62:

ED 62 is based on International Financial Reporting Standard (IFRS) 9, *Financial Instruments*, developed by the International Accounting Standards Board (IASB®). In developing ED 62, the IPSASB applied its *Process for Reviewing and Modifying IASB Documents* which requires public sector modifications where appropriate.

This approach enables the IPSASB to build on best practices in private sector financial reporting, while ensuring the unique features of the public sector are addressed.

The project stage:

The IPSASB issued this ED in August 2017.

Next steps:

The IPSASB seeks feedback on ED 62 to guide it in developing a final International Public Sector Accounting Standard® (IPSAS®) that establishes accounting requirements for financial instruments.

Comment deadline:

ED 62 is open for public comment until December 31, 2017.

How to respond:

Respondents are asked to submit their comments electronically through the IPSASB website, using the "[Submit a Comment](#)" link on the ED page. Please submit comments in both a PDF and Word file. All comments will be a matter of public record and will be posted on the website.

Why the IPSASB Undertook this Project

The purpose of the IPSASB's project is to improve financial reporting for financial instruments, by addressing weaknesses in, and reducing the complexity of, the existing requirements.

IPSAS 29, *Financial Instruments: Recognition and Measurement*, is based on the International Accounting Standards Board's (IASB) financial instruments standard as at December 31, 2008.

In July 2014, the IASB replaced its *Financial Instruments: Recognition and Measurement* standard with IFRS 9, *Financial Instruments*. The IASB's goal was to address stakeholder concerns with its existing literature in which the requirements for reporting financial instruments were found to be complex and the information provided to users was insufficient.

Maintaining convergence with International Financial Reporting Standards (IFRS) is a key priority for some jurisdictions which have adopted and implemented IPSAS. Constituents in those jurisdictions have indicated that unnecessary differences between IPSAS and IFRS Standards are costly and the IPSASB should continue to reduce differences in a timely manner. *The IPSASB'S Strategy for 2015 Forward: Leading Through Change* re-confirmed maintaining IFRS convergence as a strategic priority.

The IPSASB concluded that the requirements in IFRS 9 are improvements compared to existing IPSAS because they are more principles-based and have been developed to address issues with the existing financial instruments standards.

This ED provides users of financial statements with more useful information than IPSAS 29, by:

- Applying a single classification and measurement model for financial assets that considers the characteristics of the asset's cash flows and the objective for which the asset is held;
- Applying a single forward-looking expected credit loss model that is applicable to all financial instruments subject to impairment testing; and
- Applying an improved hedge accounting model that broadens the hedging relationships in scope of the guidance. The model develops a strong link between an entity's risk management strategies and the accounting treatment for instruments held as part of the risk management strategy.

Examples of Financial Instruments

Financial instruments can represent a significant proportion of an entity's assets and liabilities. However, because the instruments have developed a reputation of being complex, many constituents find them daunting.

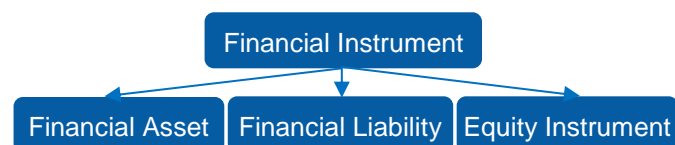
What is a financial instrument?

Many financial instruments are simple in nature and commonly used in every day transactions.

Financial instruments such as cash, accounts receivable and loans are a necessity of operation and are required for sound fiscal management of any public sector entity. Without financial instruments the operations of public sector entities – along with those of private sector entities and citizens – would grind to a halt.

Financial instruments: are contracts that give rise to both a financial asset in one entity and a financial liability or an equity instrument in another.

Figure 1: Types of financial instruments



Financial assets

A financial asset, simply put, is cash, an equity instrument of another entity, or a contract to receive cash at a future date.

Common financial assets: The most commonly used financial assets are cash, or a contract to receive cash. These instruments are the lifeblood of any entity and are used in most routine transactions. Common financial assets include:

- Accounts receivables;
- Loans receivable, including concessionary loans; and
- Investment certificates (Treasury Bills).

Not to be confused with financial assets: The following instruments are not financial assets:

- Statutory receivables; and
- Prepaid balances.

Examples of Financial Instruments

While many financial instruments are routine in nature, a subset exists – which includes hedging transactions and derivative instruments – which have created a reputation of complexity for financial instruments as a whole.

Financial liabilities

A financial liability is a contractual obligation to deliver cash or another financial asset to another entity.

Common financial liabilities: Similar to financial assets, many financial liabilities are routinely used in daily transactions. Any time an entity has an obligation to deliver cash, it has a financial liability.

Common financial liabilities include:

- Bank overdraft;
- Accounts payable; and
- Borrowings (including bonds, loans and concessionary loans).

Equity instruments

Equity instruments represent an interest in the net assets of another entity. Equity instruments are often common shares or other types of investment in another entity.

Complex instruments - hedging

Hedging is a strategy used to reduce volatility associated with an identified risk.

For example, an entity may reduce its exposure to movement in a foreign currency by locking in an exchange rate today for a transaction that will be settled at a future date.

Complex instruments - derivatives

A derivative is a contract that settles in cash in the future, where the future cash flows change based on another variable such as an interest rate, commodity price or foreign exchange rate.

For example, a contract to purchase 100 foreign currency units in 3 months is a derivative because the future cash flows exchanged are dependent on the underlying exchange rate between the currencies.

Common derivatives: Common derivatives include:

- Foreign exchanges forwards/futures contracts;
- Interest rate swaps; and
- Options.

Sometimes a derivative is embedded in a contract where the cash flows of the combined instrument vary in a way similar to a standalone derivative. These are common in contracts for the purchase or sale of items denominated in a foreign currency. While the purchase or sales contracts is not a derivative, embedded is a derivative to purchase or sell a foreign currency.

The Classification and Measurement Approach

IPSAS 29 contained many different classification categories. Classification was rule-based and could be complex and challenging to apply in practice.

ED 62 reduces complexity by replacing the existing classification and measurement categories for financial assets with principles-based categories.

A principles-based approach to classification and measurement

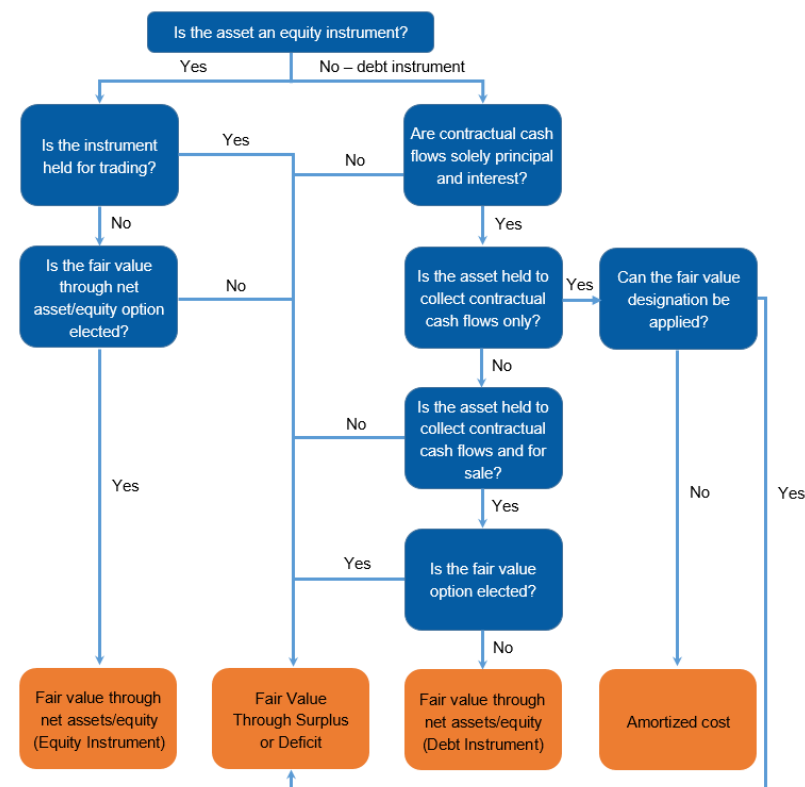
The classification of financial assets is the foundation for the requirements for how financial assets are measured on an ongoing basis, and the requirements for impairment and hedge accounting.

ED 62 applies one approach for classification of all financial assets. The two criteria used to determine how financial assets should be classified and measured are:

- The entity's management model for managing the financial assets; and
- The contractual cash flow characteristics of the financial asset.

ED 62 also allows an entity to elect to account for financial assets at fair value.

Figure 2: Determining the classification and measurement of financial assets



The classification approach outlined in Figure 2 also applies to financial assets containing derivatives. This eliminates the need for the existing complex bifurcation requirements in IPSAS 29.

A Forward-looking Impairment Model

The forward-looking impairment model is designed to provide users of financial statements with information on expected credit losses that is more useful and timely.

Overview of the impairment requirements

The incurred loss impairment model in IPSAS 29 has been criticized for resulting in delayed recognition of losses – as an entity can only recognize impairments when there is objective evidence indicating that a loss event has occurred, even if a loss has been likely for some time.

Compared to the existing impairment model, ED 62 provides a single forward-looking model that eliminates the threshold for impairment recognition. It is no longer necessary for a trigger event to occur prior to recognizing a credit loss.

The forward-looking model requires an entity to recognize expected credit losses at all times. The model uses a dual measurement approach whereby expected credit losses are measured as either 12-month expected credit losses or lifetime expected credit losses.

Due to its forward-looking nature, the ED 62 model broadens the information that an entity is required to consider when it determines its expectation of credit losses. Consequently, more timely information is required to be provided about expected credit losses and it provides financial statement users the ability to make better decisions.

Figure 3: Stages of impairment

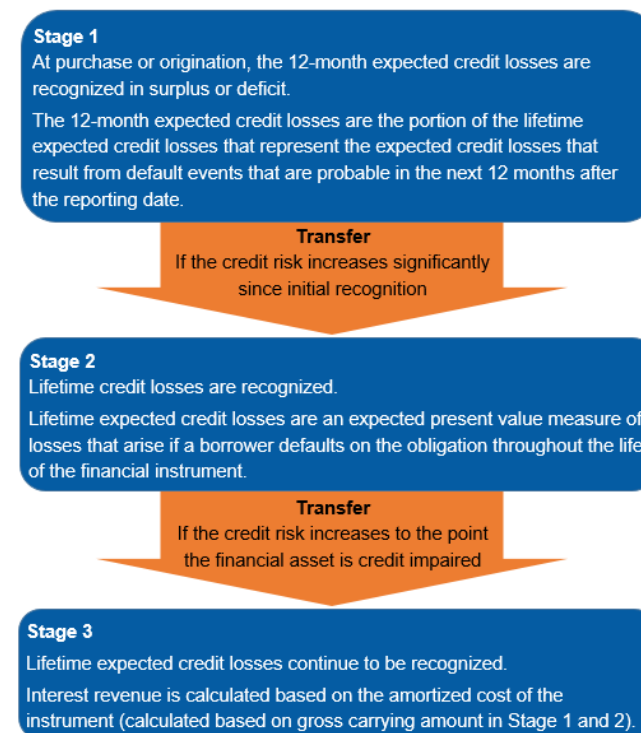


Figure 3 outlines the stages of impairment. However, figure 3 omits more intricate situations – such as originated or purchased credit impaired financial assets – to reduce the complexity of the diagram.

A Better Link Between Hedge Accounting and Risk Management

ED 62 improves hedge accounting requirements by more closely aligning the accounting with an entity's risk management practices.

The need for a change

The hedge accounting requirements in IPSAS 29 were developed when hedging activities were not as widely understood as they are today.

Criticisms of the hedge accounting requirements in IPSAS 29 include that they fall short of providing financial statement users the ability to:

- Understand the risks an entity faces;
- Understand what an entity is doing to manage the risks; and
- Evaluate the effectiveness of those risk management strategies.

The new model enables more entities to apply hedge accounting, and for entities to more closely reflect their actual risk management activities.

Closer alignment with risk management

The revised hedge accounting requirements are more principles-based than those in IPSAS 29. They avoid the previous arbitrary rule-based requirements, enabling the alignment of hedge accounting more closely with the risk management practices adopted when hedging financial and non-financial risks.

This enables entities to better reflect their risk management practices in their financial statements.

Public sector specific considerations

The IPSASB evaluated the unique characteristics of public sector entities in revising the financial instruments standards. Additional guidance and examples were provided as necessary.

Transactions unique to the public sector

In its conceptual framework, the IPSASB identifies a number of factors which differentiate the public sector from the private sector.

In developing this ED on accounting for financial instruments – using IFRS 9 as a base – the IPSASB considered transactions prevalent or unique to the public sector and included additional guidance.

Guidance carried forward from IPSAS 29:

IPSAS 29 included additional guidance related to the public sector. This guidance – updated for consistency with the principles in ED 62 – was carried forward in the Exposure Draft. This guidance includes:

- Loans with concessionary elements.
- Fair value measurement considerations including inputs to valuation techniques.
- Rights and obligations arising from non-exchange revenue transactions.

Additional guidance and illustrative material

included in ED 62: Further to the public sector specific examples carried forward from IPSAS 29, new public sector material was added. This includes:

- Additional illustrative examples related to loans with concessionary elements.
- Fair value measurement guidance specific to the valuation of unquoted equity instruments.
- Equity transactions with a non-exchange component.

Next Steps

The deadline for comments is December 31, 2017.

During the comment period, IPSASB members are available to discuss the proposals with a wide range of parties.

How can I comment on the proposals?

The ED includes Specific Matters for Comment (SMCs) on which the IPSASB is seeking views.

Respondents may choose to answer all SMCs or just a selected few. The IPSASB welcomes comments on any other matter respondents think the IPSASB should consider in forming its views.

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All comments will be considered a matter of public record and will be posted on the IPSASB website.

The IPSASB will consider all feedback and discuss responses at its public meetings after the comment period has ended.

Stay informed

The IPSASB’s website will indicate the meetings at which feedback on the ED 62 will be discussed. The dates, and the locations of the 2018 meetings are at:

<http://www.ipsasb.org/meetings>

To stay up to date about the project, please visit:

<http://www.ipsasb.org/projects/financial-instruments-update-project>