



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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Agenda Item

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DATE: June 9, 2008
MEMO TO: Members of the IPSASB
FROM: Matthew Bohun-Aponte and John Stanford
SUBJECT: Financial Instruments

OBJECTIVE OF THIS SESSION

To **review, discuss and agree** the Rules of the Road analysis and the proposals in the Issues Paper on financial instruments, so that marked-up drafts of Exposure Drafts (EDs) at the October 2008 IPSASB meeting.

AGENDA MATERIAL

3.1 Issues Paper – “Financial Instruments in the Public Sector”

ACTION REQUIRED

The IPSASB is asked to:

- **Discuss the issues and proposals** as outlined in the Issues Paper – “Financial Instruments in the Public Sector”; and
- **Provide** staff with direction on issues to be addressed in the development of EDs for the October 2008 IPSASB meeting.

BACKGROUND

At previous IPSASB meetings, the IPSASB identified the necessity of developing IPSASs addressing the IASB’s updated requirements for the presentation and disclosure of financial instruments. At the meeting in March 2008 the IPSASB also concluded that it should develop an IPSAS addressing the recognition and measurement of financial instruments. The IPSASB concluded that a comprehensive financial instruments project should be initiated that includes components for development of:

- IPSASs based on IFRS 7, “Financial Instruments: Disclosures”, IAS 32, “Financial Instruments: Presentation” and IAS 39, “Financial Instruments: Recognition and Measurement”; and
- An IPSAS dealing with certain public sector specific items.

The IPSASB decided that the project should initially develop Exposure Drafts that had minimal variations from the IFRSs, and it would further debate key issues and determine if the approach tentatively agreed in Toronto could be effectively implemented in the public sector. The Issues Paper at item 3.1 discusses a number of issues that will arise in the development of the EDs and staff proposals for addressing them. In developing the

Issues Paper, the “Discussion Paper on Financial Instruments”, issued by the Accounting Standards Board of South Africa (SAASB) and the “Statement of Principles: Financial Instruments”, issued by the Canadian Public Sector Accounting Board (PSAB) were particularly helpful. Staff acknowledges gratefully the assistance of the Staff of the SAASB and the PSAB.

Guidelines for Modifying IASB Documents

As for all newly initiated IFRS convergence projects, the starting point is an analysis of public sector issues using the IPSASB, “Guidelines for Modifying IASB Documents” (Rules of the Road). These have been applied to IFRS 7, IAS 32 and IAS 39 to determine the approach to the project, i.e., whether financial instruments should be an IFRS convergence project or whether a public sector specific project is needed.

Step 1: Are there public sector issues that warrant departure?

In applying the rules in step 1, public sector issues are assessed to determine if they warrant a departure in recognition, measurement, presentation or disclosure requirements. Staff has identified a number of issues in reviewing the IFRSs from a public sector perspective.. These issues are explored in greater detail in the Issues Paper.

Rule #1: Where applying the international accounting standards/interpretations would mean the objectives of public sector financial reporting would not be met.

Definition and Recognition Issues

There are a number of public sector specific issues related to the definition and recognition of financial instruments (see Issues Paper 3.1 for a fuller exploration). Issues that could lead to public sector financial reporting objectives not being met are:

- **Definition of Financial Instruments:** There are a number of items in the public sector that are generally regarded as assets or liabilities, but do not meet the IASB’s definition of a financial instrument, financial asset or financial liability:
 - Items that do not satisfy the IFRS definition of a financial instrument because they do not have a counterparty. These include monetary gold, special drawing rights in the International Monetary Fund, the reserve position in the IMF and currency issued by the entity.
 - Items that do not arise from contracts, but through another binding arrangement such as the operation of law; for example, from legislation. Examples of these instruments include taxes receivable, transfers receivable and payable and fines receivable.
 - The definitions of a financial asset and a financial liability include certain contracts that will or may be settled in an entity’s own equity instruments. Very few public sector entities that are not Government Business Enterprises (GBEs) will have their own equity instruments.

- **Future service potential:** When defining assets in the public sector, previous IPSASs have broadened the term “future economic benefits” to “future economic benefits or service potential.” This has implications for the measurement of assets and liabilities at fair value, as public sector entities may hold financial instruments for the generation of service potential rather than economic benefits.
- **Classification and reclassification of instruments:** The IFRSs require the classification of financial assets into four categories on initial recognition, which impacts the subsequent measurement of those instruments. IAS 39 strictly limits the circumstances under which reclassification may take place. In the public sector, over time, the availability of market prices for different instruments changes, and this may warrant a more flexible approach to reclassification than in IAS 39 .
- **Concessional loans;** Concessional loans are different in substance to below market rate loans in the private sector. In the public sector concessional loans are advanced to further the social and economic policies of the lender, whereas in the private sector these are typically advanced for a fee and are exchange transactions
- **Substance versus form;** IAS 32 deals with some cases where a financial instrument will have the legal form of equity, but the substance of a financial liability. However, in the public sector what appear to be liabilities may in substance be a contribution from owners.
- **Additional guidance:** Additional guidance is necessary to address public sector situations, such as:
 - Risks associated with financial instruments arising from non-exchange transactions;
 - Approaches to hedging in the public sector;
 - Substance versus form of public sector specific transactions;
 - Disclosure of market risk associated with public sector specific financial instruments;
 - Determination of the effective interest rate in the public sector;
 - Determination of fair value in the absence of quoted prices in an active and liquid market;
 - Identification of embedded derivatives in the public sector.

In all these areas, Staff believes that the objectives of providing “information useful for decision making” would not be met unless they are addressed either by modifying the IFRSs to reflect the public sector differences or by establishing a public sector specific project. Staff have included more specific proposals in the Issues Paper at item 3.1.

Rule #2: Where applying the international accounting standards/interpretations would result in a loss of accountability to stakeholders.

Staff believes that failing to address the issues identified at Rule#1 would also cause a loss of accountability to stakeholders. It is important that public sector standards address the issues commonly faced by public sector entities, and not only those events and transactions that are common to entities in private sector. Financial instruments and items that have many of the characteristics of financial instruments, but are non-contractual, have the potential to impact significantly a public sector entity's financial performance, financial position and cash flows. It is, therefore, essential that the IPSASs establish appropriate requirements for the recognition, measurement, presentation and disclosure of all financial instruments and that items that arise from non-contractual binding arrangements are addressed appropriately.

The current classification requirements in IAS 39 can be seen as risking accountability by leading to similar instruments being measured in different ways and by promoting management intention above accounting consistency. A converse view is that accounting should reflect the economic reality of an entity's approach to the management of financial instruments. On balance, Staff does not think that there is an adequate public sector case for departing from the requirements in IAS 39. However, additional commentary is necessary.

Similarly, hedge accounting can be seen as impairing accountability as it is based on management intention and leads to similar assets and liabilities being measured in different ways dependent upon whether they have been designated for hedging. The converse view is that where items are deployed in a hedging relationship, a failure to reflect such a relationship risks accountability more than a measurement mismatch between assets. On balance, Staff does not think that there is a sufficiently strong case for eliminating hedge accounting altogether, but that there is scope for additional guidance on the approach to hedging in the public sector.

Rule #3: Where applying the international accounting standards/interpretations would mean the qualitative characteristics of public sector financial reporting would not be met.

The IPSASB is addressing qualitative characteristics in its Conceptual Framework project. The existing IPSASB qualitative characteristics are Understandability, Relevance, Reliability and Comparability.

The IPSASB has previously established that in the public sector financial assets and liabilities can arise not only from contracts, but also from non-contractual arrangements that are legally enforceable. Such arrangements include, but are not necessarily limited to rights and obligations arising from legislation, judicial decisions, international treaties, and non-contractual agreements between parties. Staff has proposed the introduction of a definition of binding arrangements that includes both financial instruments that are contracts and non-contractual arrangements

Staff are of the view that without this amendment, the IPSASs would fail to address material transactions in the public sector and that this would have a negative impact on all the current qualitative characteristics.

Rule #4: Where the cost of applying the international accounting standards/interpretations exceeds the benefit.

Staff acknowledges the view that the IFRSs addressing financial instruments are complex, difficult to interpret and difficult to apply, which leads to higher costs in preparing financial statements.. However, adverse movements in the fair value of financial instruments have the potential to affect materially the financial position, performance and cash flows of an entity. It is, therefore, important that users of a public sector entity’s financial statements are provided with sufficient information to make an assessment of the risks an entity faces and to be able to understand an entity’s policies for managing that risk. In general, Staff is of the view that the benefits of applying IPSASs based on the IFRSs will, ultimately, exceed the costs.

Staff acknowledges that the disclosure in IFRS 7 on the sensitivity of financial instruments to market risk is onerous. The cost of producing such a disclosure is not commensurate with the benefits that users will derive from it for a number of financial instruments, such as those that are of a non-exchange nature, concessional loans and loans and receivables.

IAS 39 requires financial guarantees to be measured at the higher of the amount initially recognized (the consideration) or the amount determined by IAS 37, “Provisions, Contingent Liabilities and Contingent Assets.” In many cases, public sector entities do not charge a fee for issuing a financial guarantee. Staff is of the view that requiring an entity to obtain a fair value measurement for a guarantee provided at zero consideration is onerous and that is more appropriate to recognize such guarantees in accordance with IPSAS 19, “Provision, Contingent Liabilities and Contingent Assets.”

Summary of Step 1 – Analysis:

Areas of consideration	Issue Identified	Comments
1) Cause objectives of financial reporting not to be met?	Definition – rights accruing from non-contractual binding arrangements	Particularly an issue for subsequent measurement
	Definition – items with no identifiable counterparty	Highly significant for a small number of public sector entities.
	Future service potential as well as economic benefits	Financial instruments may be held primarily for service potential rather than economic benefits.

	Classification and reclassification of financial instruments.	Due to nature of financial assets determination of fair value may not be straightforward.
	Concessional loans	Issues differ from those of “off-interest market loans.”
	Additional guidance	Need for additional guidance identified in areas such as the treatment of concessional loans and determination of fair value for certain non-quoted investments.
2) Affect the accountability to stakeholders?	Definition of financial instruments: non-contractual binding arrangements	Accountability to shareholders could be compromised unless non-contractual binding arrangements are addressed.
3) Cause qualitative characteristics not to be met?	Definition of financial instruments: non-contractual binding arrangements	Relevance likely to be undermined if public sector specific items are not addressed.
4) Where cost of applying exceeds the benefit.	Disclosure on sensitivity analysis of market risk Financial guarantee at zero consideration	Generally, benefit of applying IFRS based IPSASs (appropriately modified) expected to exceed costs. Cost of information on sensitivity analysis of market risk disproportionate to benefit for simpler public sector financial instruments. Cost of obtaining a fair value of a guarantee provide with no consideration not commensurate with value of such information to users

Conclusion Step 1: Staff concludes that there are several public sector issues that warrant a departure:

- Binding arrangements;
- Items that do not have an identifiable counterparty
- Future service potential and its application to the measurement of assets and liabilities at fair value;
- Classification and reclassification of financial instruments;
- Concessional loans; and
- Additional application guidance.

Therefore in applying the guidelines we need to proceed to step 2.

Step 2: Are the departures so significant that a public sector specific project should be initiated?

Public sector specific items: The public sector specific items identified at Step 1 (monetary gold, special drawing rights in the International Monetary Fund, the reserve position in the IMF and currency issued by the entity) are best dealt with through a separate public sector specific component of the project as they give rise to issues that cannot be adequately addressed within an appropriate timescale in an Exposure Draft developed by modifying an IFRS. While these items are highly significant at whole-of-government level and for a small number of entities they will not affect the majority of public sector entities and Staff thinks that the time taken to develop EDs based on IAS 32, IFRS 7 and IAS 39 should not be extended by including such items in the IFRS component of the overall project

Binding arrangements; IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)” provides a precedent for including “binding arrangements” within the scope of an IPSASs and including accounting requirements. In the Issues Paper, Staff have proposed that the definitions of “financial instrument”, “financial asset” and “financial liability” be amended to include non-contractual “binding arrangements”. The term “binding arrangements” would also be defined and would include assets and liabilities arising from non-exchange transactions as a result of legislation and other legally enforceable arrangements as well as contractual arrangements. Staff is of the view that the IPSASs would be materially deficient without these amendments, but that it is not necessary to initiate a public sector specific project.

Future service potential: Many financial instruments in the public sector are held to further a government’s or public sector entity’s social and economic policies. Determining the fair value of the future service potential attaching to these items is not as straight forward as measuring the fair value of an instrument that only embodies economic potential in the form of future flows of cash or other resources. The IFRSs do not address future service potential, so must be modified to address this important public sector dimension to financial instruments. This does not necessitate a public sector specific project.

Classification and reclassification of financial instruments: Staff is of the view that additional guidance is necessary for the classification of financial instruments, in particular financial assets, and that modification is necessary to the requirements for the reclassification of financial instruments to ensure that appropriate financial reporting occurs over time. When a financial instrument is initially recognized, there may be no market for that instrument. In subsequent periods however, a market may develop, (or vice versa). It is therefore important to modify the IFRSs to ensure that if such changes occur, their impact is reflected in the financial statements.

Concessional loans: Staff is of the view that the concessional loans offered by public sector entities are fundamentally different from the loans offered by commercial lenders, whether at market rates or below market rates (off-market interest rates). Commercial lenders lend at below market rates either for a fee, or as part of a promotional opportunity. In such case, the IASB has decided that it is appropriate to recognize costs associated with the discount in the period in which the loan is advanced. In the public sector, concessional loans are advanced to further the social and or economic policies of a government or public sector entity, and are advanced in circumstances where a borrower would not or cannot access commercial lenders. Therefore it may be inappropriate to use the same financial reporting requirements, commentary and application guidance in respect of these loans. Staff is of the view that modifications in the form of additional commentary or disclosures to the IFRSs are required when developing the IPSASs in respect of concessional loans. Concessional loans do not necessitate a public sector specific project.

Financial guarantees at zero consideration: Staff considers that requiring entities to recognize and disclose financial guarantees at zero consideration by immediate reference to IPSAS 19, “Provision, Contingent Liabilities and Contingent Assets” rather than by requiring the estimation of a fair value measurement are small. This is a relatively small issue and does not necessitate a public sector specific project.

Application guidance: Application guidance and other implementation and illustrative guidance accompanying the IFRSs do not address public sector specific financial instruments and transactions. To be useful to public sector financial statement preparers and the users of the financial statements, additional guidance addressing public sector specific situations will be needed, as outlined under step 1 above and in the Issues Paper. Additional issues may also be identified as the project develops and may be included in the proposed IPSASs.

Conclusion Step 2: Staff concludes that the majority of public sector issues that warrant departure can be addressed within a converged IASB document with some modification. Step Three will consider the parameters for the extent of modification allowed. However, the public sector specific items identified at Step 1 (monetary gold, special drawing rights in the International Monetary Fund, the reserve position in the IMF and currency issued by the entity) are best dealt with through a separate public sector specific component of the project.

Step 3: Modify IASB documents

As noted, staff believes that there are number of issues in the public sector that would call for modification under Step 3 of IFRS 7, IAS 32 and IAS 39. These situations have been identified under steps 1 and 2 above and in the Issues Paper at item 3.1.

The first criterion in Step 3 of the guidelines indicates that recognition and measurement requirements may be modified, if doing so will result in the objectives of public sector financial reporting being better met. Staff believes that the modifications proposed above would both enhance the usefulness of information for decision makers, as indicated in the current IPSAS objectives. Information on how an entity utilizes financial instruments to meet its operating objectives will be much clearer and more comprehensive if the modifications outlined above and discussed in the Issues Paper are made.

Step 3 also indicates that amendments may be made to the scope to be consistent with existing IPSASs. Staff believes that the modifications proposed are consistent with the existing IPSASs, in particular IPSAS 23.

Modification considerations	Definition	Future Service Potential	Classification and Reclassification	Concessional Loans	Additional Guidance/
i) Result in objectives of public sector financial reporting being better met	Yes	Yes	Yes	Yes	Yes
ii) An alternative that better achieves the objective	N/A	N/A	N/A	N/A	N/A
iii) Eliminate options	N/A	N/A	N/A	N/A	N/A
iv) Guidance for public sector context	Yes	Yes	Yes	Yes	Yes
v) Modify disclosure	TBD	N/A	Yes	Yes	Yes
vi) Add public sector example	Yes	Yes	Yes	Yes	Yes

vii) Amendments to scope to be consistent with existing IPSAS	Yes, IPSAS 23	Yes	N/A	Yes, IPSAS 23	Yes
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Conclusion Step 3: Staff concludes that the issues identified can be addressed by modifying IASB documents with the exception of the public sector specific items identified at Steps 1 and 2 (monetary gold, special drawing rights in the International Monetary Fund, the reserve position in the IMF and currency issued by the entity).

Step 4: Make IPSAS style and terminology changes to IASB documents

The standard changes to the IASB document to reflect IPSAS style and terminology will be made in preparing the ED.

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Issues Paper: Financial Instruments in the Public Sector

Background

At its meeting in March 2008, the IPSASB reviewed a proposal by Staff to revise IPSAS 15, “Financial Instruments: Presentation and Disclosure” in accordance with the IASB’s revisions to IAS 32, “Financial Instruments: Presentation” and to develop a new IPSAS that converges with IFRS 7, “Financial Instruments: Disclosure”. This proposal also recommended that, as part of this project, the IPSASB address certain public sector specific financial instruments including monetary gold, Special Drawing Rights in the International Monetary Fund (IMF) and currency issued by the entity. The IPSASB discussed this proposal and concluded that some constituents were currently applying the provisions of not only IAS 32 and IFRS 7 but also IAS 39, “Financial Instruments: Recognition and Measurement”. Consequently, the IPSASB concluded that it should proceed to develop and issue IPSASs based on IAS 32, IAS 39 and IFRS 7.

In addition to developing these IPSASs, the IPSASB also decided that it would initiate a separate component of the project to address certain public sector specific financial instruments, including those identified above; – the IPSASB noted that the public sector specific financial assets identified above are generally classified as “reserve assets” and are held by the monetary authority of a national government. Similarly currency is normally only issued by the monetary authority of a national government. These are important issues at a national government level, but do not affect the majority of public sector entities. Consequently, the IPSASB decided that while these issues are an important component of the financial instruments project, developing financial reporting requirements for them should be considered separately from the component of the project dealing with IFRS convergence.

General Issues

IASB Work Program

At the meeting in March 2008, the IPSASB tasked the Chair and Senior Technical Manager with contacting the IASB to determine the IASB’s realistic expectations concerning major changes to their Financial Instruments standards. Informal discussions with the IASB liaison member and IASB staff in late March 2008 indicated that there would be no fundamental changes to the IFRSs on Financial Instruments requirements in the next 3 years and it is unlikely that there will be fundamental changes within a 5 year time frame. IASB Staff do, however, anticipate that there will be annual improvements and periodic amendments to the Standards to deal with emerging and urgent issues. It has also been suggested that, in view of the global credit crunch more extensive disclosure requirements might be introduced, particularly regarding liquidity, although it is unclear what these might be.

IASB Discussion Paper “Reducing Complexity in Reporting Financial Instruments”

In early 2008, the IASB issued a Discussion Paper, “Reducing Complexity in Reporting Financial Instruments” with comments requested by September 19, 2008. identifies

intermediate and long term steps that might be taken to reduce the complexity of financial reporting of financial instruments. The Paper argues that the complexity of the financial reporting has arisen mainly due to the different measurement requirement of different classes of financial instruments. It identifies intermediate and long term steps that might be taken to reduce the complexity of financial reporting of financial instruments.

The Paper discusses three possible intermediate solutions to reduce the complexity of financial reporting of financial instruments:

- (a) To amend measurement requirements (e.g., by reducing the number of categories of financial instruments);
- (b) To replace the existing requirements with a fair value measurement principle and some optional exceptions to fair value measurement; and/or
- (c) To simplify hedge accounting.

The approaches could be taken forward in isolation or some combination of them could also be developed.

The long term solution discussed in the Paper focuses on measuring all financial instruments in the same way. The Paper argues that the only measurement attribute that provides relevant information for all types of financial instrument is fair value. The definition of fair value would be crucial in developing this approach: the IASB also has a current project to establish general principles in determining fair value. Many preparers and users are concerned that measuring financial instruments at fair value introduces volatility to the financial statements. However, both the IASB and the Financial Accounting Standards Board remain committed to fair value measurement.

The Discussion Paper outlines both intermediate and long term approaches that the IASB will consider after the responses to the Discussion Paper have been received in September. Given the IASB's due process, any fundamental revisions to the IFRSs as a result of this DP are likely to be at least three years away. IPSASB Staff are of the view that, whilst this project should and will be monitored, the IPSASB should not delay its own convergence project pending the outcome of this project, or any intermediate steps.

Staff Proposal and Action Required

Staff **proposes** that, in light of the discussion with IASB members and Staff, IPSASs based on current versions of IAS 32, IAS 39 and IFRS 7 should be developed. Members are asked to **confirm** this view.

Interpretations of the International Financial Reporting Interpretations Committee (IFRICs)

There are two current Interpretations of the International Financial Reporting Interpretations Committee (IFRICs) that primarily relate to the suite of IFRSs on financial instruments. IFRIC 2, "Members' Shares in Co-operative Entities and Similar Instruments" relates to IAS 32 and IAS 39 and IFRIC 9, "Reassessment of Embedded Derivatives" relates to IAS 39. It is currently intended that a "Guidelines for Modifying

IASB Documents” (Rules of the Road) analysis of these documents will be brought to the October meeting. IFRIC D22, “Hedges of a Net Investment in a Foreign Operation” is expected to be ratified by the IASB in June 2008, and relates to IAS 39. In a subsequent section of this Issues Paper, Staff proposes that there is no need to incorporate requirements on the hedging of a net investment in a foreign operation in an IPSAS based on IAS 39. If this proposal is not agreed, a Rules of the Road analysis will also be applied to the finalized Interpretation. In accordance with the proposal for dealing with IFRIC Interpretations on the agenda for this meeting, the optimal approach will be to incorporate the substance of the Interpretations into the body of the ED.

Staff Proposal and Action Required

Staff **proposes** that, a Rules of the Road analysis of IFRIC Interpretations primarily related to IAS 32, IAS 39 and IFRS 7 should be brought to the October meeting. Members are asked to confirm this approach.

Public Sector Issues

During the discussions at the IPSASB meeting in March 2008, and in subsequent consultations with IPSASB Members, Technical Advisors and Observers, a number of important issues that may have a significant impact on public sector entities have been brought to the attention of Staff. Decisions are needed on how these issues are to be addressed, if they are to be addressed, in the standards being developed. Issues to be addressed include:

- Public sector specific financial instruments outside the scope of the convergence component of the project:
 - Monetary gold
 - Special drawing rights (SDRs) in the International Monetary Fund (IMF)
 - Reserve position in the IMF
 - Currency issued by the entity
- Definition of a financial instrument: Non-contractual arrangements
- Definition of a financial asset and a financial liability: Contracts that will be settled in entity’s own equity instruments
- Classification and reclassification of financial instruments
 - Classification of financial assets for subsequent measurement
 - Reclassification of financial instruments
- Concessional loans
- Substance versus form of financial instruments
- Fair value of financial instruments
 - Fair value of non-commercial equity investments
 - Fair value of financial guarantees
- Regular way purchase or sale of a financial asset:
- Hedge accounting
- Disclosures
 - Market risk
- Further application guidance

Public Sector Specific Financial Instruments

As noted at previous meetings, Staff have identified a number of public sector specific items that do not satisfy the definitions of “financial asset”; “financial liability”; “equity instrument” or “financial instrument” in IAS 32, IFRS 7, or indeed in the current IPSAS 15. The key definitions are in paragraph 11 of IAS 32:

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A financial asset is any asset that is:

- (a) cash;
- (b) an equity instrument of another entity;
- (c) a contractual right:
 - (i) to receive cash or another financial asset from another entity; or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity;or
- (d) a contract that will or may be settled in the entity’s own equity instruments and is:
 - (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity’s own equity instruments;or
- (ii) a derivative 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 puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity’s own equity instruments. (*Staff note: paragraphs 16A-16D were introduced as a result of Amendments issued in February 2008 and deal with puttable instruments. They are not reproduced here.*)

A financial liability is any liability that is:

- (a) a contractual obligation:
 - (i) to deliver cash or another financial asset to another entity; or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity; or
- (b) a contract that will or may be settled in the entity’s own equity instruments and is:

- (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments;
or
- (ii) a derivative 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 puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.

An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Public sector entities do hold financial assets and financial liabilities that meet the above definitions and have substantially the same characteristics as financial instruments held or issued by private sector entities. Consequently, for such financial instruments, there are likely to be limited public sector issues that warrant departure from the IFRSs. (See section below, "Definition of a financial asset and a financial liability: Contracts that will be settled in entity's own equity instruments", however, for a discussion of whether the part of the definition of a liability that a contract which can be settled in an entity's own equity instruments is applicable in the public sector). There are, however, a small number of financial items that are issued and/or held by public sector entities that are not issued or held by private sector entities. Several of these do not meet the definition of "a financial instrument" as prescribed by the IFRSs. They also do not meet the definitions in the current version of IPSAS 15 and are therefore outside the scope of that IPSAS.

The public sector specific instruments identified are:

- Monetary gold
- Special Drawing Rights (SDRs) in the International Monetary Fund (IMF)
- Reserve position in the IMF
- Currency issued by the entity

Monetary Gold

Monetary gold is gold bullion or coins of at least 995/1000 purity that is officially designated as being part of a country's official reserve assets. Ordinarily, monetary gold will be held by a country's central bank, or other monetary authority. Some countries measure monetary gold at the fair value of the metal, other countries measure monetary

gold at its historic cost. The International Monetary Fund (IMF) classifies monetary gold as a financial asset of the central bank, notwithstanding that there is no counterparty, primarily due to gold's historical role in the monetary system.

Under current IPSASs, monetary gold is not distinguished from other gold, and is recognized as property under IPSAS 17, "Property, Plant and Equipment". As indicated above it is not presented as a financial instrument.

Special Drawing Rights

Special Drawing Rights (SDRs) are international reserve assets created by the IMF and are an unconditional right to obtain foreign currency from other members of the IMF. SDRs are only held by the monetary authorities of IMF member countries and a limited number of international financial institutions. There is an active secondary market in SDRs and the price of SDRs is quoted in the financial press on a daily basis. SDRs, as currently defined, provide an asset for the holder, but there is no corresponding liability recognized by either the IMF or the members of the IMF. At most, IMF members might disclose a contingent liability in respect of a possible call by the IMF to provide foreign currency.

Under current IPSASs, SDRs would be recognized as an asset, principally because they can be sold on the secondary market. If this market did not exist, an entity might interpret an SDR as a contingent asset rather than as an asset. As SDRs do not satisfy the current definition of a financial asset, they would not be presented as a financial instrument, nor would the disclosures required by IFRS 7 apply to them.

Reserve Position in the IMF

A country's reserve position in the IMF has the characteristics of a reserve asset. A reserve tranche position in the IMF arises from (a) the payment of part of a member's subscription in reserve assets and (b) the IMF's net use of the member's currency. Normally a member's reserve tranche position is equal to its "quota" less the adjusted IMF holdings of its currency, less subscriptions receivable, less balances held in the administrative accounts of the IMF to the extent they are not in excess of 0.1 percent of a member's quota, if positive.

When a country joins IMF, it is assigned a quota that fits into the structure of existing quotas considered in the light of the member's economic characteristics relative to those of other members of comparable size. The size of the member's quota determines, among other things, the member's voting power, the size of its potential access to Fund resources, and its share in allocation of SDRs. Quotas are reviewed at intervals of not more than five years to take account of changes in the relative economic positions of members and the growth of the world economy. Initial subscriptions, and normally subscriptions associated with increases in quotas, are paid mainly in the member's own currency, and a smaller portion, not exceeding 25 per cent, are paid in reserve assets (SDRs or other members' currencies that are acceptable to the Fund).

If membership of the IMF is a contractual agreement between the IMF and its member countries, then a country's reserve position might satisfy the definition of an equity instrument. If membership is more in the nature of a binding arrangement, then the

definition of equity instrument is not satisfied. If the reserve position in the IMF does not represent a residual interest in the net assets of the IMF then it does not meet the definition of an equity instrument, but would be treated as a financial asset as its value is tied to that of the SDR. Staff has been forwarded an extract from the New Zealand Whole of Government Accounts for 2007 that indicates that the reserve position at the IMF is identified as a financial asset in the Statement of Financial Position.

Currency Issued by the Entity

Cash on hand is included within the definition of a financial asset in IPSAS 15. This definition does not, however, deal with the situation of those financial institutions in the private or public sector that issue currency. Currency issued by an entity can be interpreted as a zero coupon, perpetual debt instrument, which might be considered net assets/equity. The general practice for financial institutions issuing currency is to treat it as a liability of the entity. The preliminary Staff view is that this treatment should be reflected in any standard issued by the IPSASB.

The IPSASB discussed these financial instruments at the March 2008 meeting and made a preliminary decision that it was more appropriate to address them in a separate component of the financial instruments project rather than in the convergence component. If this approach is agreed a more detailed Issue paper with firmer Staff proposals will be brought to the October meeting.

Staff Proposal and Action Required – Reserve Assets

Staff **proposes** that the convergence component of this project have within its scope the public sector specific items identified in this section of the Issues Paper. An Issues Paper dealing with these issues in more detail should be brought to the October meeting. Members are asked to **confirm** this approach and also to identify other public sector specific items that need to be addressed in this component of the project.

Definition of a financial instrument: Non-contractual financial instruments

An issue that has been raised by some Members and by some public sector standard setters is whether the scope and/or definitions derived from IAS 32 need to be modified to ensure that non-contractual arrangements are addressed. Non-contractual arrangements arise through legislation or otherwise through the operation of law. Such non-contractual arrangements can give rise to assets for a reporting entity and to liabilities for other entities within the jurisdiction. Similarly, reporting entities can transfer resources to other entities without entering contracts, thereby incurring a liability on themselves, and giving rise to an asset for a third party.

As noted above, the current IFRSs and IPSAS 15, “Financial Instruments: Presentation and Disclosure” define a financial instrument as “any contract (staff emphasis) that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.” This component of the definition flows through into the definitions of financial assets and financial liabilities. If the IPSASB adopts this definition without modification, arrangements and transactions that arise from legislation or other operation of law will be outside the scope of the IPSASs, for example, involuntary items such as taxes receivable and payable, and fines receivable and payable or transactions related to

non-contractual agreements such as transfers receivable and payable. IPSAS 23 currently addresses the initial recognition of assets and certain liabilities that arise from non-exchange transactions, but does not address subsequent recognition.

The South African Accounting Standards Board (SAASB) addressed these issues in its February 2008 Discussion Paper on financial instruments. The SAASB identified four options for addressing these transactions and arrangements that have many of the characteristics of financial instruments but do not meet the IAS 32 definition of a financial instrument, because they are not contractual. Staff considers that these options are highly relevant for the IPSASB project and have therefore included them in this Issues Paper with very minor modifications:

1. Amend the definition of financial instrument to “any binding arrangement that gives rise...” The ASB proposed defining “Binding arrangement” as:
 - (a) Any arrangement arising out of:
 - (i) A contract,
 - (ii) Legislation, or
 - (iii) Operation of law,
 - (b) Which has clear economic consequences that either party has little or no discretion of avoiding, and
 - (c) Conveys legal rights or legal obligations on either party, which are enforceable by law.
2. Retain the definitions of financial instruments, financial assets and financial liabilities in IAS 32, but develop specific scope inclusions for non-contractual arrangements and then deal with them on the same basis as financial instruments.
3. Exclude all non-contractual arrangements from the scope of the standards on financial instruments and develop a separate standard that addresses only non-contractual arrangements.
4. Develop a single standard, split into distinctive sections, dealing with both financial instruments (arising out of contractual arrangements) as well as non-contractual binding arrangements.

Each of these options has advantages and disadvantages. Options 1 and 2 address the public sector issues in a comprehensive manner, by modifying a definition that is likely to be familiar to constituents and is being applied by some public sector entities, without completely rewriting the suite of standards. However they result in divergence from the IFRSs and the definitions in those IFRSs with which constituents may be familiar. Staff notes that, as well as the definition of a “financial instrument”, the definitions of “financial asset” and “financial liability” would need to be similarly amended.

Option 3 would likely lead to pronouncements that are most convergent with the IFRSs, but commits the standard setter to a resource intensive project to address items that are held by the majority of public sector entities, but do not meet the existing definitions in IAS 32. The Public Sector Accounting Board in Canada (PSAB) excluded from the scope

of any proposed standard on financial instruments taxes and any other non-discretionary, non-contractual transfers.

Option 4 has the advantage of consolidating requirements for financial instruments (as defined in IAS 32) and other binding arrangements in one Standard. However, the development of separate sections on assets and liabilities arising from non-exchange transactions is likely to consume an equivalent amount of resources and time as option 3 and would likely replicate large sections of the IFRSs.

In addition, although the term “binding arrangement” has been used in a number of IPSASs, for example, IPSAS 11, “Construction Contracts,” it has not been defined. The issue of binding arrangements was addressed specifically in IPSAS 23, primarily because many non-exchange transactions in the public sector are of an involuntary, non-contractual nature. After considerable debate the IPSASB concluded that IPSAS 23 had to include transactions that are broader than contracts, but that could be enforced through legal means. Given the IPSASB’s previous deliberations on the nature of binding arrangements, Staff favors Option 1.

Staff Proposal and Action Required – Non-contractual financial instruments

Staff **proposes** that the IPSASB adopt Option 1, amending the definitions of “financial instrument”, financial asset” and “financial liability” to include non-contractual binding arrangements and defining “binding arrangements”. Members are **asked** to confirm this approach.

Definition of a financial asset and a financial liability: Contracts that will be settled in entity’s own equity instruments

The definitions of a financial asset and a financial liability in IAS 32 (shown above) include certain contracts that will or may be settled in the entity’s own equity instruments. While some public sector standard-setters have adopted the definition in IAS 32 substantially unamended, in South Africa and Canada public sector standard setters have proposed deleting this part of the definition. Staff considers that this proposal has considerable merit in simplifying the definition as the settling of transactions in an entity’s own equity instruments will be unlikely in the public sector outside Government Business Enterprises (GBEs). Members’ experiences in their own jurisdictions will determine whether this proposal is appropriate.

Staff Proposal and Action Required – Definition of a financial liability

Staff **proposes** that, the definitions of a financial asset and a financial liability in IAS 32 are amended to delete references to “contracts that will or may be settled in an entity’s own equity instruments.” Members are **asked** for their views.

Classification and reclassification of financial instruments

Classification

IAS 39 requires entities to recognize financial instruments initially at fair value, plus, in the case of a financial asset or financial liability not at fair value through profit or loss,

transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

At initial recognition IAS 39 requires entities to classify financial assets into one of four categories;

- Financial assets designated at fair value through profit or loss (the fair value option)
- Held-to-maturity investments
- Loans and receivables
- Available-for-sale financial assets

The categorization is important because it dictates the subsequent measurement basis. After initial recognition, financial assets are measured at their fair values (without any deduction for transaction costs that may be incurred on disposal) except for:

- Loans and receivables and held-to-maturity investments, which are measured at amortized cost using the effective interest rate method; and
- Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured, which are measured at cost. Derivatives that are linked to, and must be settled by, delivery of unquoted equity instruments are also measured at cost.

After initial recognition, all financial liabilities are measured at amortized cost using the effective interest rate method, except for:

- Financial liabilities at fair value through profit and loss, which are measured at fair value, except for certain specified derivative liabilities ;
- Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when what is known as the continuing involvement approach applies. In these cases the entity continues to recognize the asset, and recognizes a liability for the consideration received; and
- Financial guarantee contracts which are measured at the higher of the amount determined in accordance with IAS 37, "Provisions, Contingent Liabilities and Contingent Assets" and the amount initially recognized less any cumulative amortization recognized in accordance with IAS 18, "Revenue".

The effective interest rate method is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or when appropriate, a shorter period. It is a method of determining the carrying amount and periodic charges or credits to surplus or deficit of a financial instrument from the expected cash flows. Ignoring impairment, the carrying amount at any point in time of a financial instrument carried at amortized cost is the carrying amount on initial recognition plus the interest taken to surplus or deficit less the cash paid or received- both interest and principal. Therefore for a financial liability, the movement in the carrying amount for a financial period equals interest expense charged to surplus and deficit for the period less cash paid- both principal and interest- in the period.

Some public sector accounting standard setters have adopted (or are in the process of adopting) this classification and the requirements for subsequent measurement, for example, Australia, New Zealand and the United Kingdom central government sector. However, guidance in the UK central government sector has suggested that the fair value

categories will not be used widely. Similarly, the UK Local Government Statement of Recognized Practice (SORP) adopts the UK GAAP equivalent of IAS 39, but notes that the vast majority of financial assets of local government entities will fall into the categories of loans and receivables-in which case measurement is at amortized cost using the effective interest rate- and available-for-sale financial assets-fair value with no deduction for transaction costs that might be incurred on sale or other disposal. The SORP does not permit local authorities to designate financial assets as held-to-maturity on the grounds that it would make different authorities' financial statements less comparable.

One complicating factor, from public sector and IPSASB perspectives is that gains or losses on available-for-sale financial assets under IAS 39 are required to be recognized in other comprehensive income, except for impairment losses until the financial asset is derecognized, when the gains or losses are recycled. Prior to the issuance of the revised IAS 1, "Presentation of Financial Statements" in 2007 such gains or losses were required to be taken through the statement of changes in equity. The IPSASB has not yet considered the revised IAS 1, so, if the IAS 39 classification is adopted, it will be necessary to take such gains and losses initially to the statement of changes in net assets/equity.

Other public sector standard setters, for example the SAASB, have argued that the classification schemes in IAS 39, and particularly the classification scheme for financial assets, are inappropriate. The grounds for this include that they are "over academic", too complex and based on management intention.

The Public Sector Accounting Board (PSAB) in Canada has proposed a simplified classification system and accounting requirements that uses amortized cost for measurement subsequent to recognition, except for instruments that it specifically defines. Instruments that are to be measured at fair value include derivatives, most investments quoted in an active market and by an entity that has opted to designate items at fair value under specific conditions. The PSAB considers that the option to designate instruments at fair value reduces "accounting mismatches", where assets and liabilities being managed together are on different measurement bases, and thereby reduces the need for hedging. The PSASB proposal is, in fact, more permissive than IAS 39 because it allows designation to fair value to take place after initial recognition (see below on Reclassification).

PSAB considered and specifically rejected the accounting for the available-for-sale financial instruments and therefore did not propose the adoption of such a category. PSAB concluded that the accounting in IAS 39, "established to mitigate volatility in reported earnings while maintaining the principle that fair value provides the most relevant basis of measurement was not relevant to financial reporting by governments." In reaching this conclusion, it weighed the qualitative characteristics that define information relevant to financial statement users and which contribute to the reliability of that information. In PSAB's view, the potential for greater use of fair value measurement (hence increased completeness) allowed through the available-for-sale category is not warranted by the potential loss in neutrality and understandability that would occur when gains and losses on assets, otherwise identical, are treated differently in measuring

surplus/deficit for the period.” PSAB concluded that gains and losses arising on financial instruments carried at fair value are relevant in assessing the stewardship of the resources entrusted to the government and, as such, should be reported in surplus or deficit except when hedge accounting directs otherwise.

The proposed IFRS for Small and Medium-sized Enterprises (SMEs) also puts forward a simplified approach to classification; in contrast to the PSAB the SME approach defines the category of financial instruments that can be measured at amortized cost and requires other financial instruments to be measured at fair value.

Staff acknowledges the view that the classification of financial assets and subsequent measurement requirements in IAS 39 are complex and that the use of management intent risks diminishing comparability and impairing accountability. As discussed in an earlier section of this Issues Paper, the IASB itself has acknowledged this complexity in its recent Discussion Paper. Staff also thinks that the approach proposed by the PSAB and the PSAB’s reservations about the appropriateness of the available-for-sale category in the public sector have great merit. On balance, Staff is not, however, at this stage, fully persuaded that there is a clear cut public sector reason to depart from the requirements of IAS 39. Staff considers that the PSAB rationale for including a fair value option in the public sector is persuasive.

Staff does consider that public sector relevant commentary should be developed to provide guidance on the type of financial instruments that are classified in each category. In addition, if an ED reflecting the current classification scheme is developed, Staff considers it essential to include a specific matter for comment on this issue. If adopted the category “financial assets designated at fair value through profit or loss” will need to be re-termed “financial assets designated at fair value through surplus or deficit” in order to reflect IPSASB terminology.

Staff Proposal and Action Required – Classification of Financial Instruments

Staff **proposes** that the classification scheme in IAS 39 should be used in drafting the ED of an IPSAS based on IAS 39. Public sector commentary should be developed and a specific matter for comment included in the ED on this issue. Members are asked to **agree** this approach.

Reclassification

IAS 39 also prescribes when entities may reclassify financial instruments between the various categories. In particular, IAS 39 expressly prohibits the reclassification of a financial instrument into or out of the category “at fair value through profit or loss” while it is held or issued by the entity. IAS 39 also places requirements on how held-to-maturity investments that have to be reclassified are treated and imposes restrictions on the ability of entities to use the held-to-maturity classification, if they have reclassified more than an insignificant amount of these instruments in the previous two years.

Other public sector standard setters, notably the PSAB and the SAASB have not proposed such a restrictive position, preferring to permit entities to reclassify if a quoted price becomes available, or ceases to be available. However, PSAB and SAASB do not

propose to permit entities to reclassify constantly. Reclassification is only permitted once. As noted above, both the SAASB and PSAB have proposed a simpler classification system to that in IAS 39.

The principle behind limiting reclassification is to prevent entities continually changing their accounting policies to enable the reporting of financial results that management considers advantageous. Staff considers that such a risk does exist in the public sector and that potentially it endangers the objectives of financial reporting. Therefore restrictions on classification are necessary in the public sector.

While acknowledging the need for controls on reclassification, Staff is of the view that the IAS 39 position is over-restrictive and will not further the objectives of financial reporting in the public sector, because it may impose an onerous requirement on entities to use an inappropriate and costly measurement technique when no quoted prices are available. Staff is of the view that the position proposed by the SAASB better promotes the objectives of financial reporting in the public sector and therefore proposes that a variant of this is adopted. Staff proposes that the ED permit entities to reclassify a financial instrument into or out of the category “fair value through surplus or deficit” when fair value becomes reasonably determinable, or ceases to be reasonably determinable, but that no further reclassification is permitted. Staff does not think that the requirements in relation to held-to-maturity investments should be modified.

Staff Proposal and Action Required – Reclassification of Financial Instruments

Staff **proposes** that the IPSASB permit entities to reclassify a financial instrument into or out of the category “fair value through surplus or deficit” when fair value becomes reasonably determinable, or ceases to be reasonably determinable, but that no further reclassification is permitted. Members are asked to **agree** this approach to reclassification.

Concessional loans/Loans offered at interest rates below prevailing market rates

Concessional loans (also called soft loans) are loans offered to a borrower at an interest rate below that which the borrower could obtain from a for-profit lending institution in an arm’s length transaction. Concessional loans may include loans made by international financial institutions and bilateral and multilateral development agencies to national governments or their controlled entities, such as those that fall within the definition of external assistance in the Cash Basis IPSAS, “Financial Reporting under the Cash Basis of Accounting”. Concessional loans may also be made by an entity to individuals, households, not for profit entities or business entities, usually within the same jurisdiction, in order to further the reporting entity’s social and economic policies.

Staff has identified 3 approaches to initial recognition of concessional loans:

- Identify the fair value in accordance with the approach adopted for “off-market interest loans” in IAS 39 and expense immediately the difference between the fair value of the loan and amount of the loan;

- Identify the fair value in accordance with the approach adopted for “off-market interest loans” in IAS 39 and amortize the difference between the fair value of the loan and the amount of the loan over the period of the loan; and
- Treat the concessional loan market as a completely different market to the commercial loan market and take the amount loaned as the fair value of the loan.

IAS 39 deals with “off-market interest” loans in Application Guidance; in such cases a lender makes a loan that has an interest rate below market rate for similar loans and receives an up-front fee in compensation. However, the IASB has not directly addressed the types of concessional loan that are non-exchange arrangements typically offered by public sector entities. In such arrangements the lender is unlikely to receive up-front fees.

Paragraphs AG64 – AG65 of IAS 39, require that off market interest rate loans be initially recognized at the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for similar instruments (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. The difference between the amount of the loan and the present value of the inflows is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

If a public sector lender were to apply this approach to a concessional loan, the entity would determine the fair value by estimating the present value of all future cash receipts discounted using the prevailing market rate of interest for a loan with a similar term to a borrower with a similar credit rating. The difference between the amount of the loan and the present value of the future cash flows would be a subsidy or grant and would be immediately expensed. Public sector entities that make concessional loans and apply IAS 39 or a similar national standard, do apply this approach. While there may have been some initial disquiet about the effects, which may require additional explanation in the notes or the management commentary, they have transitioned to the IAS 39 regime.

Subsequent accounting will require the loan’s effective interest rate to be used. This will be higher than the contractual interest rate, since the initial carrying amount of the loan is less than the principal sum required to be repaid. The effective interest rate will in fact be the same as the interest used to determine the present value of the concessional loan. This will result, over the term of the loan, in the carrying amount of the loan being written up to the amount it would have been if it had not been accounted for as a concessional loan and interest income being credited to surplus or deficit over and above the contractual interest. The amount in excess of the contractual interest would be equal to the write-down of the concessional loan on initial recognition.

A variant of this approach is to require the difference between the amount of the loan and the fair value to be amortized over the life of the loan, using either an effective rate of interest method or on a straight line basis, rather than to be expensed immediately. In the view of Staff amortization is likely to be favored by those who favor identification of any “subsidy” but stress the importance of accounting treatments reflecting “inter-period equity.”

An alternative approach is based on the view that concessional loans made by public sector entities are, in many circumstances, made outside of the commercial marketplace,

and should be treated differently. In support of this view they can adduce the point that, unlike in the commercial market place, an upfront fee would not be paid to the lender.

During the development of IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)” the IPSASB considered whether borrowing entities should recognize transfer revenue when they entered a concessional loan agreement. At that time the IPSASB concluded that because the concessional loan market was effectively a completely different market to the commercial loan market, the interest rate on concessional loans was the prevailing interest rate in the concessional loan market and that these loans should be measured by borrowers at the present value of future cash payments discounted at the interest rate implicit in the loan agreement. Therefore, no transfer revenue should be recognized by an entity in receipt of a concessional loan. Adopting this approach, the fair value of a concessional loan on initial recognition for the lender would be the amount of the loan.

Staff acknowledges the view that where a loan is made on concessional terms its carrying amount should be based on terms available in a concessional market rather than a commercial market. However, in economic substance, the difference between the amount lent and the present value of inflows, determined on a market related basis, constitutes a subsidy or grant. Staff considers that such a subsidy/grant should be identified. While Staff acknowledges the view that this subsidy/grant should be written off over the life of the loan, Staff considers that this is conceptually inappropriate and that the difference should be written off to surplus or deficit at the inception of the loan. Adoption of this treatment would entail the reopening of the approach discussed in the development of IPSAS 23.

Staff Proposal and Action Required – Concessional Loans

Where a concessional loan is provided, Staff **proposes** that the ED should reflect a requirement that, on initial recognition, the difference between the amount of the loan and the present value of inflows determined on a market related basis constitutes a subsidy or grant. Members are **asked** to agree this approach

Substance versus form of financial instruments

IAS 32 notes that sometimes a financial instrument will have the legal form of equity, but the substance of a financial liability, for example, redeemable preference shares. In the public sector the converse situation may be more common; an arrangement may have the form of debt, but in substance be a contribution from owners. This can occur when one public sector entity “lends” resources to a controlled entity with conditions attached, with the expectation that if the entity meets the pre-agreed conditions, the loan will be forgiven and will form part of the controlled entity’s net assets/equity. These types of situations are not addressed in IAS 32.

There are other transactions within the public sector that raise financial reporting issues that do not cause controversy in the private for-profit sector. These transactions between controlling and controlled entities involve the distinction between contributions by owners and lending, and between interest payments and “capital charges” or dividends and similar distributions.

Staff Proposal and Action Required – Substance versus form of financial instruments

Staff **proposes** that additional mandatory application guidance can be added to the IPSAS equivalent of IAS 32 to facilitate the distinction between lending and contributions from owners, and related revenue, expenses and distributions to owners, in the public sector. This guidance would build on the material that was included in IPSAS 23 and its predecessor invitation to comment. Members are asked to **agree** this approach.

Fair value issues

Fair value of non-commercial equity investments

At initial recognition IAS 39 requires entities to determine the fair value of financial assets, including non-traded equity investments. This can be particularly difficult in the public sector when the investment is in an entity that does not, nor is it intended to, generate positive cash inflows for the investor, for example a private sector not-for-profit entity. IAS 39 provides guidance on estimating the fair value of investments in equity instruments that do not have a quoted market price in active market. Further, after initial recognition, IAS 39 does permit investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured to be measured at cost. However, IAS 39 does not address the circumstances identified above. It is therefore important that an IPSAS

Staff Proposal and Action Required– Fair value of non-commercial equity investments

Staff **proposes** that the IPSAS contain application guidance on the determination of the fair value of non-commercial equity investments. Such guidance will be developed based on the experience of jurisdictions where public sector that have implemented/are implementing IAS 39. Members are asked to **agree** this approach.

Fair value of financial guarantees

Governments and other public sector entities regularly provide financial guarantees for loans or other liabilities of public sector entities, individuals and households, private sector not-for-profit entities and for profit entities. These guarantees are usually provided to further the social or economic policies of the government or entity providing the guarantee.

Under IAS 39, financial guarantee contracts are a liability of the issuer and are measured at the higher of the amount initially recognized (the consideration) or the amount determined by IAS 37, “Provisions, Contingent Liabilities and Contingent Assets.”

In many cases, public sector entities do not charge a fee for issuing a financial guarantee. The key issue is whether, in accounting for financial guarantees provided at zero consideration, there should be a requirement at initial recognition for entities to obtain a fair value for the guarantee, either by reference to the amount charged by other entities for similar guarantees or through a valuation technique. The alternative is that entities are not required to obtain a fair value measurement, and that they recognize the guarantee in accordance with IPSAS 19, “Provisions, Contingent Liabilities and Contingent

Assets”. Under IPSAS 19 the guarantee would only be recognized if it is probable that a payment would have to be made in accordance with the terms of the guarantee. The entity would be required to disclose a contingent liability unless the possibility of an outflow of resources in relation to the guarantee is remote.

Staff is of the view that requiring an entity to obtain a fair value measurement for a guarantee provided at zero consideration is onerous and that the value to users of the financial statements of such a measurement is questionable. In addition, in some circumstances it would be difficult to obtain a fair value, because the entity receiving the guarantee would not meet a financial institution’s criteria for receiving such a guarantee; therefore there is an issue over the reliability of any fair value estimate. Where a fee is received Staff’s preliminary view is that there is not a public sector reason to depart from the requirements of IAS 39.

Staff Proposal and Action Required– Fair value of financial guarantees

Staff **proposes** that the ED should not require an entity to obtain a fair value measurement for a guarantee provided at nil cost and that the guarantee should be accounted for in accordance with IPSAS 19. Where a fee is received Staff proposes that the requirements of IAS 39 should be adopted. Members are **asked** to agree this approach,

Regular way purchases or sales

A regular way purchase or sale is defined in IAS 39 as “a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.” IAS 39 gives entities the option of using either trade date accounting or settlement date accounting for regular way purchases or sales, provided that the method is used consistently for all purchases or sales of financial assets that belong in a particular category. The trade date is the date on which an entity commits itself to purchase or sell an asset. The settlement date is the date that an asset is delivered to or by an entity.

Public sector standard setters in South Africa, Canada and the United Kingdom have specified or proposed that trade date accounting should be used. While Staff accepts that removing accounting options is generally beneficial and that the trade date probably reflects the timing of rights and obligations better than the settlement date there does not appear to be any public sector specific reason to depart from the requirements in IAS 39 relating to right of way purchases.

Staff Proposal and Action Required – Regular way purchases or sales

Staff **proposes** that the accounting options in IAS 39 are retained for accounting for regular way purchases or sales. Members are **asked** to agree this approach,

Hedge Accounting

The section of IAS 39 on hedge accounting is the most complex part of IAS 39. In IAS 39 hedge accounting recognizes the offsetting effects on profit or loss of changes in the

fair values of the hedging instrument and the hedged items. The IFRSs recognize three types of hedging relationships:

1. A fair value hedge is a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or an identified portion of such an asset, liability or firm commitment that is attributable to a particular risk and could affect profit or loss.
2. A cash flow hedge is a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognized asset or liability (such as all or some future interest payments on variable rate debts) or a highly probable forecast transaction and (ii) could affect profit or loss.
3. A hedge of a net investment in a foreign operation, as defined in IAS 21, "The Effects of Changes in Foreign Exchange Rates". Such hedges are dealt with similarly to cash flow hedges.

Hedging instruments are normally derivatives. Non-derivative financial assets and non-derivative financial liabilities are only permitted as hedging instruments for foreign currency risk.

The objective of fair value hedge accounting is to eliminate or reduce "accounting mismatches" that arise when hedging instruments at fair value and hedged items are measured in different ways. Fair value hedge accounting changes the way the hedged item is measured to match more closely the measurement of the hedging item with the objective that gains and losses on the hedging item offset gains and losses in the hedged item. Under IAS 39 if the hedge is deemed highly effective (see below) such gains and losses on the hedging item are taken to profit and loss while the gain or loss on the hedged item is reflected in the carrying amount of the hedged item and is recognized in profit or loss. This applies if the hedged item is otherwise measured at cost or amortized cost.

Cash flow hedge accounting affects the timing and recognition of gains and losses on hedging items rather than the measurement of financial instruments. To the extent that the hedge is highly effective, gains and losses on the hedging instrument are recognized temporarily in other comprehensive income. Such deferred gains and losses are recycled into profit and loss in later periods. The ineffective portion of gains and losses on the hedging instruments is recognized in profit and loss.

Hedges of a net investment in a foreign investment are accounted for in a similar way to cash flow hedges with the effective portion of the gain or loss on the hedging instrument being recognized in other comprehensive income and the ineffective portion being recognized in profit or loss. When the foreign operation is disposed of, the gain or loss relating to the effective portion is recycled in to profit or loss.

In paragraph 88 IAS 39 lists five criteria that must be satisfied for a hedging relationship to qualify for hedge accounting:

1. At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.
2. The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.
3. For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.
4. The effectiveness of the hedge can be reliably measured, i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.
5. The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

In the public sector, governments and their controlled entities are subject to risks of changes in fair value and variability of cash flows in the same way as private sector entities. Many public sector entities are aware of the risks and rewards to the entity's financial position, performance and cash flows that derivative financial instruments offer. To manage these risks, many governments adopt global risk management strategies that are applicable to all controlled entities and restrict the extent to which controlled entities can engage in hedging activities. An example of such a policy is shown below. Even where central policies such as this are not in place, the involvement of many public sector entities in hedging is likely to be limited to foreign currency hedges when they have a commitment with an overseas supplier.

Example: Foreign Exchange Risk Management Policy of the Australian Government

Overarching Principle

The overarching principle of the policy is that:

General Government Sector (GGS) entities are responsible for the management of their foreign exchange risks. However, they will not act to reduce the foreign exchange risk that they would otherwise face in the course of their business arrangements.

This means that GGS entities should not undertake any form of hedging. Under the framework, any arrangement that attempts to reduce foreign exchange risk is considered to be a hedge and is, therefore, contrary to the Australian Government's policy.

As GGS entities are prohibited from acting to reduce foreign exchange risks, for the purposes of this policy, 'managing' means identifying, measuring, monitoring and reporting foreign exchange exposures, as well as being able to identify whether an arrangement will constitute a hedge under the policy.

Rather than allowing GGS entities to enter into individual hedging arrangements, the Australian Government has taken a decision to self-insure foreign exchange exposures and not accept the additional costs associated with hedging. This is based on the view that, as a large organisation, the Commonwealth has a broad spread of assets and liabilities and a range of revenues and expenses, both geographically and across classes, which assists in the management of movements in exchange rates. This means that arrangements that mitigate foreign exchange risk are viewed as being unnecessary.

GGS entities should bear this overarching principle in mind in interpreting the policy.

IAS 39 and IFRS 7 contain detailed requirements on how to appropriately account and disclose transactions that qualify as hedging transactions. To the extent that these governments use contractual financial instruments to manage market risks, Staff anticipate that they will do so through a central entity that is staffed by financial market experts. For these entities, therefore, the hedge accounting provisions are not likely to present an insurmountable challenge.

There is an issue whether the hedging provisions in the IFRSs should be retained at all in the development of an IPSAS based on IAS 39. Even the IASB Discussion Paper acknowledged, without accepting, the view that eliminating hedge accounting might address some of the problems in the financial reporting of financial instruments. Staff is not convinced that allowing entities to net off exposed positions and thereby introduce greater complexity into financial reporting enhances the objectives of financial reporting. A reasonably strong case can be made that hedging impairs the transparency of the financial statements and thereby risks reducing the ability of the financial statements to meet user needs. In particular, a central aspect of fair value hedging is that the designated hedged item is measured on a basis other than that at which it would be carried, so that its measurement is consistent with that of the hedging item. This means that similar items can be measured in different ways- Staff concedes that the same criticism can be aimed at the fair value option.

Notwithstanding these concerns, where public sector entities engage in hedging relationships, there is no apparent public sector reason to preclude the same treatments as permitted and required by the IFRSs for fair value and cash flow hedges. Staff notes the

PSAB conclusion that “it was not swayed by arguments that financial reporting by governments involving derivatives or their use in hedging relationships should be fundamentally different from requirements for businesses and not-for-profit organizations. The assertion that governments are distinct because they are not issuers of derivatives, nor actively speculate on market outcomes does not hold, as in the majority of cases, businesses and not-for-profit organizations do not engage in such activities.” It will be necessary to modify commentary to reflect the point that in many instances for an economic entity approaches to risk management will be centrally determined and controlled entities are unlikely to engage in hedging. Even if there are hedging arrangements these are likely to be for limited foreign exchange purposes, such as when an entity has a contract for supply of an item of equipment and the contract has to be settled in a foreign currency. It may also be worth emphasizing in commentary or guidance that judicious use of the fair value option can significantly reduce the need for fair value hedging.

Staff further notes that the PSAB examined the case for including the hedging of a net investment in a self-sustaining foreign operation in the types of permitted hedges. In researching these proposals, PSAB concluded that foreign operations of government are typically financially or operationally interdependent with the government. Although some agencies have features that suggest they may be self-sustaining, they generally borrow based on a sovereign guarantee and therefore would not qualify. PSAB concluded that the exposure to exchange rate changes for the foreign operations of governments is similar to the exposure that would exist had the transactions and activities been undertaken by the government itself. Staff thinks that the PSAB has made a persuasive case and that hedges of a net investment in a foreign operation should not be included in the ED of a draft IPSAS. A specific matter for comment should be inserted on this issue.

Staff Proposal and Action Required – Hedge Accounting

Staff **proposes** that the IPSASB retain the hedging requirements of IFRS 7, IAS 32 and IAS 39 in the IPSASs, except for the hedging of a net investment in a foreign operation. Additional public sector specific commentary and guidance should be included. Members are **asked** to agree this approach.

Disclosures

IFRS 7 requires a large number of disclosures in order to provide users of the financial statements the significance of financial instruments for an entity’s financial position and performance and qualitative and quantitative information about exposure to risks arising from financial instruments. IFRS 7 is explicit that the IFRS applies to all entities, including entities that have a few financial instruments, while noting that the extent of disclosure depends on the extent of the entity’s use of financial instruments and of their exposure to risk. At Toronto, some members noted at the last meeting that IFRS 7 contained a number of quite complex disclosure requirements and questioned whether all of these are necessary in the public sector. Staff has reviewed the disclosures required by IFRS 7, which are summarized as:

- (a) Information that enables user of the financial statements to evaluate the significance of financial instruments for financial position and financial performance;

- (b) Categories of financial instruments (Statement of Financial Position);
- (c) Financial assets and financial liabilities through profit and loss including disclosure of credit risk, mitigation of that risk, changes in that risk not due to general market conditions;
- (d) Reclassification of financial instruments;
- (e) Derecognition of financial instruments;
- (f) Collateral related to financial assets;
- (g) Allowance for credit losses;
- (h) Compound financial instruments with multiple embedded derivatives;
- (i) Defaults and breaches by the entity on financial liabilities;
- (j) Items of income, expense, gains or losses;
- (k) Accounting policies
- (l) Hedge accounting;
- (m) Fair value disclosures:
 - a. Fair value of each class;
 - b. Limited offsetting of instruments at fair value;
 - c. Basis of determining fair value;
 - d. Fair value in the absence of a liquid market
 - e. Disclosures of fair value are not required when:
 - i. Carrying amount approximates fair value;
 - ii. There is no market for an equity instrument and fair value is not reasonably determinable;
 - iii. A contract has a discretionary participation feature and the fair value of that feature is not reasonably determinable;
- (n) Nature and extent of risks arising from financial instruments;
 - a. Qualitative disclosures
 - b. Quantitative disclosures;
 - c. Credit risk
 - i. Financial assets that are past due or impaired
 - ii. Collateral and other enhancements obtained
 - d. Liquidity risk
 - e. Market risk:
 - i. Sensitivity analysis (including currency risk);
 - ii. Other market risk disclosures.

The areas covered by the disclosures are extensive. Most of the disclosures are essential if an entity has extensive dealings in financial instruments that are traded on the capital markets. It is questionable, however, whether such extensive disclosures are required in respect of financial instruments that arise from non-exchange transactions and simple exchange transactions.

Users of a public sector entity's financial statements do require information on how the entity is managing the risks associated with non-exchange transactions appropriately; that is, that the entity is taking appropriate steps to ensure prompt payment of taxes, fines, and other receivables, and that the entity is managing any payables associated with non-exchange transactions appropriately. Users of public sector entity financial statements will also be particularly interested in the level of an entity's debt and other financial liabilities, and whether there are appropriate controls in place to ensure that market risks related to those liabilities is managed appropriately.

It should be noted that many of these disclosures will not be relevant for many public sector entities, for example, it is likely that few public sector entities will have compound financial instruments with multiple embedded derivatives and hedge accounting may not be widely used.

Disclosure of Market Risk and Sensitivity of Market Risk

IFRS 7 prescribes detailed requirements for the disclosure of market risk for each category of financial instrument held by an entity. Market risk is defined in IFRS 7 as "The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk." The components of market risk are defined thus:

- *Currency risk* is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
- *Interest rate risk* is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
- *Other price risk* is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), wither those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

Staff is of the view that a detailed sensitivity analysis is not necessary in respect of financial instruments that arise from non-exchange transactions and simple exchange transactions. For many of these instruments, as well as loans and receivables, currency risk will only arise if the instrument is denominated in a currency other than the functional currency of the entity, which will not normally be the case for many public sector entities. Interest rate risk will be an issue if the financial instrument has an interest rate that is significantly different from the market interest rate. Other price risk will occur for public sector financial instruments in the same way that it occurs for all financial instruments. Users of public sector entity's financial statements will be aware that public

sector entities use financial instruments to further their, or their controlling entity's, social and economic policies, therefore they will anticipate that the returns on investment obtained by public sector entities will not reflect those obtained by commercial entities. Users will, however, expect to be informed whether the entity is unduly exposed to market risk, for example by borrowing or lending in a currency other than the functional currency of the entity.

Additional Disclosures that may be necessary

Staff considers that it may be necessary to include additional disclosures on:

- Equity instruments with the characteristics of a financial liability;
- Concessional loans; and
- Financial guarantees provided by the reporting entity at zero consideration.

Staff Proposal and Action Required– Disclosures on sensitivity of market risks and additional disclosures

Staff **proposes** that the IPSAS on require that, in respect of financial instruments arising from non-exchange transactions, concessional loans and loans and receivables, entities be required to disclose the currencies in which financial instruments are denominated, the interest rates that relate to those instruments, and other major market risks that could impact on the value of financial instruments or cash flows related to them. A sensitivity analysis of market risks should not be required.

Staff further **proposes** that there should be additional disclosure requirements for equity instruments with the characteristics of a financial liability, concessional loans and financial guarantees provide at zero consideration.

Members are asked to **agree** this approach

Further Application Guidance

As part of this analysis, Staff has recommended some additions to the application guidance that is included in the IFRSs. Staff is also of the view that the application guidance could usefully include additional guidance on:

- Determination of the effective interest rate, in particular for concessional loans and financial instruments arising from non-exchange transactions;
- Accounting for concessional loans;
- Approaches to hedging in the public sector;
- Risks associated with financial instruments arising from non-exchange transactions
- Disclosure of market risk associated with public sector specific financial instruments
- Determination of fair value in the absence of quoted prices in an active and liquid market;
- Substance versus form of public sector specific transactions; and
- Identification of embedded derivatives in the public sector.

In addition the illustrative examples should be augmented with examples of disclosures to be made by public sector entities, particularly in relation to transactions that are unlikely to occur in the private sector.

This additional guidance will be developed with the Exposure Drafts. Members and Technical Advisors are asked to provide examples for inclusion to Staff.

Staff Proposal and Action Required– Further application guidance

Staff **proposes** that additional application guidance is developed on a number of public sector issues. Members are **asked** to agree the issue identified and identify further issues on which guidance should be developed.