

Meeting: IPSASB Consultative Advisory Group
Meeting Location: Stellenbosch, South Africa
Meeting Date: December 5, 2016

Agenda Item 5

For:
☐ Approval
☒ Discussion
☒ Information

Financial Instruments (Updates to IPSAS 28-30)

Project summary	Development of an Exposure Draft to introduce changes to the IPSASB financial instruments standards related to the changes introduced by IFRS 9, <i>Financial Instruments</i> developed by the IASB. This project is intended to maintain convergence with IFRS financial instruments requirements.	
Meeting objectives	Topic	Agenda Item
Discussion Items	Use of Fair Value for Financial Instruments	5.1
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Item 5.1

Background

1. IPSAS 28, *Financial Instruments: Presentation*, IPSAS 29, *Financial Instruments: Recognition and Measurement* and IPSAS 30, *Financial Instruments: Disclosures* are based on the IASB's financial instruments standards as at December 31, 2008.
2. This project's scope is to update IPSAS 28-30 to maintain convergence with the IASB literature for IFRS 9, *Financial Instruments* which was issued in 2014. The IPSASB approved the project in December 2015 and it was initiated in the second quarter of 2016, with the first agenda items presented at the June 2016 meeting.
3. The IPSASB has a further active project to develop guidance for public sector specific financial instruments. The [public sector specific financial instruments project](#) deals with transactions which do not clearly meet the definition of a financial instrument and are public sector specific instruments.
4. Maintaining convergence with IFRSs was a key factor when considering project prioritization in the [IPSASB's Strategy for 2015 Forward](#). Further, maintaining IFRS convergence is a key priority for some jurisdictions which have adopted and implemented IPSASs. Constituents in those jurisdictions note that unnecessary differences between IPSASs and IFRSs are costly and the IPSASB should continue to reduce differences in a timely manner.
5. During the September 2016 IPSASB meeting, a board member noted that in his jurisdiction, there has been a long standing debate in the public sector, as to whether the use of fair value is in the public interest, because of the volatility introduced into the financial statements and a view that fair value reduces understandability.

This view challenges the IPSASB to:

- (a) Communicate clearly the requirements of IPSAS financial instruments standards and that fair value measurement provides relevant information for accountability and decision-making purposes in those circumstances when it is prescribed; and
 - (b) Better educate on the benefits fair value information provides to users of public sector financial statements, which is a broader issue for the accountancy profession.
6. Existing guidance in IPSAS 28-30 already requires fair value measurement in certain circumstances. The requirements in the IASB's standards from which the IPSASs are drawn reflect the view that fair value provides the most relevant information for financial instruments under most circumstances. Additionally, staff notes the following to consider in the context of fair value measurement for financial instruments:
 - (a) On initial recognition, measurement at fair value provides information that is relevant and faithfully representative of the transaction; and
 - (b) On subsequent measurement, the pervasive use of fair value is not indiscriminately proposed. Subsequent measurement at amortized cost is permitted under certain circumstances.
 7. In this short paper, staff will analyze fair value measurement concerns for financial instruments, considering the following;

- (a) The IPSASB Conceptual Framework; specifically the objectives of financial reporting and users and their information needs¹. This provides a framework to consider some of the concerns related to the use of fair value for financial instruments accounting; and
 - (b) Present ideas on how the IPSASB can better communicate the appropriateness of fair value measurement for financial instruments.
8. The specific concerns noted in regards to the use of fair value are summarized as follows:
- (a) IPSAS financial instrument standards are based on the IASB's standards and designed for the private sector and therefore are not appropriate for the public sector;
 - (b) Historical cost is more appropriate for the public sector, because cost to acquire a financial instrument or provide a loan, is often more relevant because the intention is often to hold instruments to maturity;
 - (c) Fair value measurement is complex; and
 - (d) Fair value introduces too much volatility.

Concern² 1: IPSAS financial instruments standards based on the IASB's standards and designed for the private sector and therefore are not appropriate for the public sector.

9. IPSAS 28-30 are based on the IASB's suite of financial instrument standards as at December 2008. The current project to update and/or replace IPSAS 28-30 is considering the changes effected in IFRS 9.
10. The concern that the IPSASB's standards are not appropriate because they are based on private sector standards does not appear valid for the following reasons:
- (a) The economic substance of financial instruments transactions is the same or similar in the public sector and private sector, which differs from other more public sector specific transactions related to, for example, non-exchange revenue or expense, social benefits and heritage items; and
 - (b) It is common for public sector entities and private sector entities to be counterparties in financial instruments transactions. For example, when a private bank (private investor) buys a government bond issuance, or when a public sector pension fund buys equity instruments of a publicly listed company.

Therefore, consistency in accounting requirements for similar transactions, or transactions between sectors, appears appropriate and helpful for accountability and decision-making purposes.

¹ The IPSASB's Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities (CF), defines the objectives of financial reporting and the users who those reports are intended for, summarized as follows: (a) The objectives of financial reporting by public sector entities are to provide information about the entity that is useful to users of General Purpose Financial Reports (GPFRs) for accountability and decision-making purposes ... and (b) IPSAS users are generally defined in the CF to be service recipients and resource providers who do not possess the authority to require a public sector entity to discuss the information they need for accountability and decision making purposes.

² The points discussed are presented in the context of the classification and measurement principles agreed by the IPSASB at the September 2016 meeting, included in the draft Financial Instruments Update ED under development.

11. Consistent with all convergence projects, the IPSASB considers any public sector modifications from the IASB requirements in accordance with the IPSASB policy paper, [Process for Reviewing and Modifying IASB Documents](#), as well as the appropriateness of accounting approaches with the IPSASB Conceptual Framework. The IPSASB convergence process is designed to ensure guidance for transactions in the public and private sectors is consistent when the economics of the transactions are the same. When the economics of the transaction differ, the IPSASB modifies the IASB guidance to reflect the needs of public sector. The project to develop the IPSAS 28-30 identified and developed additional public sector guidance for the following:
 - (a) Concessionary loans;
 - (b) Financial guarantees issued through non-exchange transactions;
 - (c) Changes for public sector terminology; and
 - (d) Differences in IPSAS standards requirements (IPSAS 1, *Presentation of Financial Statements*).
12. As highlighted in [paragraph 3](#) above, the IPSASB has an active public sector specific financial instruments project. This project deals with those transactions which are not prevalent in the private sector or more significant in the public sector. The public sector specific financial instruments project currently has a [consultation paper](#)³ out for comment.
13. Staff is of the view that the suite of financial instruments standards and the ongoing projects related to financial instruments are appropriately considering the public sector issues and needs of users to ensure the requirements are developed to ensure better accountability and decision-making in the public sector.

Concern 2: Historical cost is more appropriate for the public sector, because cost to acquire a financial instrument or provide a loan is often more relevant because public sector entities often hold financial instruments to maturity.

14. The primary purpose of the financial statements is to show the resources controlled by the entity and the claims against those resources. It is important to select measurement bases conducive to this purpose.
15. Often when financial instruments standards are discussed in a public sector context, an assumption is made that the measurement requirements permit only fair value. However, the requirements allow for a mixed measurement model, with subsequent measurement at either fair value or amortized cost⁴ depending on the economic characteristics of the instruments and how they are managed by the entity. For example, IFRS 9 permits measurement at amortized cost for financial assets with cash flows that represent solely payments of principal and interest on specified dates which are held within a model with an objective to collect the cash flows. Conversely, when financial assets do not give rise to cash flows that are solely payments of

³ The Consultation Paper: *Public Sector Specific Financial Instruments*, covers issues of accounting for Currency in Circulation, Monetary Gold and the IMF quota subscription and Special Drawing Rights.

⁴ Amortized cost is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

principal and interest or are held for purposes other than to collect cash flows; fair value is required.

16. Fair value measurement provides relevant information on the current cost of holding a financial instrument, and the expected cash flows from the instrument based on current assumptions and economic conditions. Fair value, therefore provides information on the current financial capacity of the financial instrument to the public sector entity. This information is important for accountability and decision-making purposes as it allows public sector entities to effectively manage financial instruments to ensure the benefits they provide (cash flows) can be estimated and planned for use to run programs to provide public sector services.
17. From a public interest perspective, the current proposals in the draft Exposure Draft (ED) for this project, consider the economic characteristics of the instruments, the entity's management model and include appropriate principals to require measurement at either fair value or amortized cost (and do not indiscriminately require fair value). The requirements being linked to the economics of the instrument and how the instruments are managed, are important principles to ensure that relevant information is provided in the financial statements for accountability and decision-making purposes.

Concern 3: Fair value measurement is complex.

18. The staff view is that the complexity of fair value measurement is a generalization and often financial instruments can be organized by their measurement complexity as highlighted below:

Category A Subsequent Measurement at Amortized Cost – Not Complex	Category B Subsequent Measurement at Fair Value – Not Complex	Category C Subsequent Measurement at Fair Value - Complex
Types of Instruments—Debt instruments, with fixed and determinable payments held to collect the cash flows.	Types of Instruments—Debt, equity or derivative instruments traded on active markets (open, active and orderly markets) and those not traded in an active market, but which can be valued using a valuation technique with market observable inputs.	Types of Instruments—Debt, equity or derivative instruments not traded in an active market, and which are valued using a valuation technique with inputs unobservable in a market.
Public Sector Example—A loan from one level of government to another (loan with a fixed maturity, market based interest rate and managed as hold-to-collect).	Public Sector Examples ⁵ : Equity Instrument—An investment in the shares (securities) of a private sector listed company – such as Apple. Debt Instrument—An investment in a government bond traded in an active market. Derivative Instrument—An investment in an option agreement (future contract) traded in an active market. The option may for example, allow the holder to buy a fixed amount of foreign currency at a set price at a specified future date.	Public Sector Examples: Equity Instrument—An investment in the shares of a private sector company that is not actively traded, and requires a valuation technique involving inputs that are not market observable Debt Instrument—An investment in a government bond, that is not traded in an active market and requires a valuation technique involving inputs that are not market observable. Derivative Instrument—An investment in an option agreement which is not traded in an active market and requires a valuation technique involving inputs that are not market observable.
Measured at: Initially at fair value which is generally the transaction price (loan amount). Subsequently at amortized cost which is the amount calculated using the effective interest method which allocates interest revenue over the life of the instrument.	Measured at: Initially at fair value which is generally the transaction price. Subsequently at fair value which is generally the quoted prices for each respective instrument in an active market at the reporting date or by using a valuation technique with market observable inputs.	Measured at: Initially at fair value – which is generally its transaction price. Subsequently at fair value which is generally estimated using a valuation technique (valuation model) at the reporting date using inputs unobservable in a market.

19. Category A transactions are not complex to value, because the initial fair value is usually the transaction price and is the amount used to calculate the amortized cost of the instrument over

⁵ The examples use those instruments traded on active markets. However, this category would also include investments which are not traded on active markets, however, are can be valued using valuation techniques with market observable inputs. For example, a forward derivative contract (is a one-to-one agreement (not traded on an active market); as opposed to a market traded futures contract). Therefore, pricing the forward contract using market observable inputs (derived from futures instruments with similar terms to the forward) as inputs into a valuation technique would be appropriate.

its contractual life. The amortized cost model uses the effective interest method, which is a simple well understood calculation that allocates interest revenue/expense systematically over the instruments contractual life. This category is thought to include a large volume of the transactions which occur in the public sector, such as loans with fixed and determinable payments, held with the intention of collecting the cash flows.

20. Category B transactions are also not complex to value, because the initial fair value is usually the transaction price. Further, subsequent fair value measurement of instruments in this category is based on an observable price in an active market, or by using a valuation technique that uses inputs which are observable in an active market. This is not an overly complex valuation exercise, for example:
- (a) A public sector pension invests in an equity instrument traded in an active market, such as Apple. The Apple investment is valued at each financial reporting using the trading price on an active market at the financial reporting date (such as the price in the New York Stock Exchange).
 - (b) This category also includes investments that may not be directly traded in an open, active and orderly market, but can be valued using valuation techniques using market observable inputs. Such as when a public sector entity invests in a forward⁶ contract for a fixed amount of foreign exchange at a specified future date. A similar investment may be available as a future⁷ contract, and therefore the forward contract can be valued using a valuation technique that uses market observable inputs.
21. Category C transactions are the ones where estimating fair value is more complex because these instruments are not traded in an open, active and orderly market, and comparable instruments, are not traded in an active market. Therefore, fair value of these instrument is estimated using a valuation technique with inputs that are not market observable. However, staff notes the following:
- (a) On initial recognition fair value will be based on a transaction price;
 - (b) Widely accepted valuation techniques and methodologies exist to determine fair value for these types of financial instruments. Often those involved in buying and selling, or in risk management functions, related to such instruments (including those in the public sector) have an understanding of the instruments fair value (and appropriate valuation techniques to estimate fair value); and
 - (c) Complex fair value estimation is required because of the complex underlying economics, structure and nature of the financial instrument.
22. From an accountability and decision-making perspective it would appear inappropriate to provide simplifications to remove complexity in identifying the measurement basis for instruments that are more complex in nature. Even though the valuation techniques are more complex for category C transactions, widely accepted techniques to value such instruments exist. Additionally, these valuation techniques are used to estimate fair value to facilitate transactions (when buying or

⁶ A forward contract is a derivative instrument that is customized directly between two private parties to trade a particular asset with each other at an agreed price at a future date. These are traded privately, not on an exchange.

⁷ A future contract is a derivative instrument to trade a particular asset at an agreed price at a future date. Future contracts are traded on exchanges and have standardized contractual terms and are governed by clearing houses which guarantee the transactions, which lowers the risk of default significantly.

selling) and often for risk management purposes, therefore the information should also be available for financial reporting purposes.

23. Staff is of the view that it may be possible to overcome the difficulties in understanding complex fair value measurements to some extent through improved communication between those tasked with buying and selling (management) of instruments and those responsible for financial reporting.
24. From a public interest perspective, the proposals in the ED appropriately reflect the economics of the transactions. When complex fair value measurement is required, this reflects the complexity of the financial instrument itself (economic nature of the instrument) and is not an accounting construct. Therefore, the requirements are appropriate to ensure that users have relevant information for accountability and decision-making purposes.

Concern 4: Fair value introduces too much volatility.

25. Financial instruments are contractual rights and obligations to future cash flows. The nature of contractual terms for some financial instruments cause their cash flows to be volatile. In such cases, the volatility of these financial instruments is not a result of the accounting, but rather a reflection of the economic characteristics of the instrument. Therefore fair value measurement conveys the current financial capacity of such instruments and directly relates to the resources controlled by the entity and the claims against those resources. Financial reporting that conveys volatility of such instruments faithfully represents the financial capacity/impact on the entity and is important for accountability and decision-making purposes.
26. Some argue that more transactions in the public sector should be measured at cost because public sector entities intend to hold the instruments to maturity and therefore the volatility throughout the life of the instruments is not relevant information. However, staff is of the view that the financial instruments standards already permits amortized cost when the contractual cash flows represent solely payments of principal and interest, which are held with an objective to collect the cash flows. Otherwise, fair value measurement is required because it provides relevant information on the timing, amount and uncertainty of cash flows reflective of the economic risks (volatility) of such instruments.
27. Volatility should be considered from a risk management perspective to determine investment/financing strategies (such informing decisions to buy and/or sell positions, or enter into hedging strategies for items with economic volatility). If volatile financial instruments are not measured at fair value, it is arguable if economic risks are faithfully represented and if the economic impact of decisions are appropriately communicated to users. This may lead to bad policy decisions that can have an adverse impact on the ability to provide services in future periods. Therefore, staff is of the view that fair value measurement for volatile financial instruments provides relevant information for accountability and decision-making purposes and is in the public interest.

Summary

28. In considering and analyzing some common concerns raised in regards to fair value measurement of financial instruments, staff is of the view that the draft ED proposals provide relevant information for accountability and decision-making purposes and are therefore in the public interest, for the following reasons:
 - (a) Financial instruments transactions with similar economics should have similar requirements in the public and private sector. Often the transactions are the same

economically in both sectors and often public sector and private sector entities are counter parties to the same transaction;

- (b) Public sector specific transactions are being considered by the IPSASB, with additional public sector requirements included in IPSAS 28-30 (carried forward in the draft ED) and under consideration in the public sector specific financial instruments project;
- (c) Fair value is not indiscriminately prescribed for all financial instruments, the draft ED proposes a dual measurement model – with amortized cost and fair value required based on the economics of the financial instruments and how the instruments are managed by the entity;
- (d) Financial instruments are sometimes complex, which should be translated into accounting guidance. So, complexity is not an accounting construct, but rather a reflection of economics of the contractual characteristics of the financial instrument; and
- (e) Certain financial instruments are volatile because of their economic characteristics, not because of the accounting requirements. Volatility impacts the fair value of financial instruments and is important for accountability and decision-making purposes (can help facilitate risk management). Measurement bases other than fair value will not help alleviate the economic volatile nature of certain financial instruments held by public sector entities.

How can the IPSASB better communicate the appropriateness of the fair value measurement for financial instruments in the public sector in its standards in relation to the concerns noted above?

29. Staff proposes a number of ways to better communicate the appropriateness of fair value measurement of financial instruments, such as the following:
- (a) Enhanced At-a-Glance documents for issuance together with Consultation Papers, Exposure Drafts and Standards, to better communicate the public interest rationale for the various accounting options included within a publication in understandable language.
 - (b) Use of outreach opportunities, such as of webinars to help with education of the concepts included within a publication in an accessible manner. As a first step in approaching this project staff has developed [educational webinars](#) to explain the concepts under consideration in an understandable manner.
 - (c) Continued use of staff communications such as the document and related podcast—[Accounting for Sovereign Debt Restructurings Under IPSAS](#), developed to respond to factual inaccuracies in media reports related to the application of IPSAS accounting standards in debt restructurings.

Issues for CAG Discussion

30. The **CAG's views are sought** on the following points:
- (a) Are there any further concerns not identified in the paper?
 - (b) Do the concerns identified and discussed in this paper, give rise to issues with financial instruments standards in your jurisdiction?
 - (c) Do you agree with the staff analysis in regards to the concerns as highlighted in this paper? and
 - (d) Do you agree with the staff view as summarized in [paragraph 28](#), that the measurement requirements proposed in the ED provide relevant information for accountability and decision-making purposes and are therefore in the public interest?

Appendix A: IPSASB Due Process Checklist (condensed to included portions relevant to the CAG)

Project: Financial Instruments (Updates to IPSAS 28-30)

#	Due Process Requirement	Yes/No	Comments
A. Project Brief			
A1.	A proposal for the project (project brief) has been prepared, that highlights key issues the project seeks to address.	Yes	The IPSASB considered the project brief at its December 2015 meeting (see Agenda Item 4)
A2.	The IPSASB has approved the project in a public meeting.	Yes	See the minutes of the December 2015 IPSASB meeting (section 4)
A3.	The IPSASB CAG has been consulted on the project brief.	N/A	<ul style="list-style-type: none"> This step is not in effect for this project.
B. Development of Proposed International Standard			
B1.	The IPSASB has considered whether to issue a consultation paper, or undertake other outreach activities to solicit views on matters under consideration from constituents.	N/A	As stated in the Project Brief, the IPSASB concluded this is a project to maintain convergence with IFRS 9, <i>Financial Instruments</i> and therefore concluded that the Consultation Paper stage was not warranted.
B2.	If comments have been received through a consultation paper or other public forum, they have been considered in the same manner as comments received on an exposure draft.	N/A	See above.
B3.	The IPSASB CAG has been consulted on significant issues during the development of the exposure draft.	N/A	See above.
D. Consideration of Respondents' Comments on an Exposure Draft			
D4.	The IPSASB CAG has been consulted on significant issues raised by respondents to the exposure draft and the IPSASB's related responses.	No	
D5.	Significant comments received through consultation with the IPSASB CAG are brought to the	No	

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#	Due Process Requirement	Yes/No	Comments
	IPSASB's attention. Staff have reported back to the IPSASB CAG the results of the IPSASB's deliberations on those comments received from the CAG.		

Appendix B: Links to Other Documents

31. This appendix provides links to document which may be useful to CAG members in providing a background related to the project.
- (a) IPSASB Financial Instruments (Updates to IPSAS 28-30) [project page](#)
 - (b) IPSASB Financial Instruments [Educational Webinars](#)
 - (c) IPSASB Financial Instruments (Updates to IPSAS 28-30) agenda items links:
 - (i) [September 2016](#)
 - (ii) [December 2016](#)