



**INTERNATIONAL FEDERATION
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Agenda Item
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Date: March 11, 2010
Memo to: Members of the IPSASB
From: John Stanford
Subject: Approach to IAS 39 Amendments & Other IASB Projects on
Financial Instruments

Objective of this Session

- To **agree** an approach to dealing with the IASB project to replace IAS 39 (through IFRS 9) and other IASB projects and amendments with an impact on the IPSASs dealing with financial instruments.

Background

1. IPSAS 28, “Financial Instruments: Presentation”, IPSAS 29 “Financial Instruments: Recognition and Measurement” and IPSAS 30, “Financial Instruments: Disclosure” were approved by the IPSASB in December 2009 and issued in January 2010 with effective dates of January 1st 2013.
2. IPSASs 28–30 are drawn primarily from IAS 32, “Financial Instruments: Presentation”, IAS 39, “Financial Instruments: Recognition and Measurement” and IFRS 7, “Financial Instruments: Disclosure.” IPSASs 28–30 addressed a limited range of public sector issues including concessionary loans and financial guarantees provided for nil or nominal consideration. They were based on IAS 32, IAS 39 and IFRS 7 as at December 31st, 2008, although certain improvements and amendments to these IFRSs proposed in late 2008, but not adopted at December 31st 2008, were incorporated at the ED stage where it had appeared highly probable that they would be adopted. IPSAS 28 included IFRIC 2, “Members’ Shares in Co-operative Entities and Similar Instruments” as an authoritative appendix. IPSAS 29 included two IFRICs as authoritative appendices: IFRIC 9, “Reassessment of Embedded Derivatives” and IFRIC 16, “Hedges of a Net Investment in a Foreign Operation.”
3. At the time of the development and approval of IPSAS 28–30 the IPSASB acknowledged that the IASB had a project underway to replace IAS 39 and that this project would result in fundamental changes to accounting for financial instruments. The IPSASB indicated that it would consider changes to the requirements of IAS 39, in order to minimize the risk that public sector entities that have adopted IPSASs will apply requirements that are more complex and onerous than those in IFRS.

4. The IPSASB has also indicated that it will examine and develop requirements on further public sector specific issues such as monetary gold, special drawing rights and currency in circulation. This paper only deals with the IPSASB's approach to IASB developments and does not discuss the approach to these public sector specific issues.

IASB Project to Replace IAS 39

5. The IASB announced its intention to revise certain aspects of IAS 39 in April 2009. The IASB has worked towards replacement of IAS 39 by a new Standard, IFRS 9, "Financial Instruments", chapters of which have been, and will be, issued on an incremental basis. There are three phases of the replacement project:
 - Classification and measurement of financial instruments;
 - Impairment; and
 - Hedge accounting.
6. The first phase dealing with classification and measurement is well underway. Chapters 4 and 5 of IFRS 9 dealing with the classification and measurement of financial assets were published in November 2009. Chapters 4 and 5 specify how an entity should classify and measure financial assets, including some hybrid contracts. They require all financial assets to be:
 - (a) Classified on the basis of the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset;
 - (b) Initially measured at fair value plus, in the case of a financial asset not at fair value through profit or loss, particular transaction costs; and
 - (c) Subsequently measured at amortized cost or fair value.
7. The requirements apply to accounting periods beginning on or after January 1, 2013, with early adoption permitted. These new requirements for financial assets represent a significant simplification of the requirements in IAS 39 that are reflected in IPSAS 29. Chapters 4 and 5 do not deal with financial liabilities. The IASB decided not to extend the new classification approach to financial liabilities until the implications of changes in 'own credit risk' could be more fully deliberated. The classification and measurement of financial liabilities is now being addressed in a separate component of Phase One. The current IASB Work Plan projects that an ED dealing with financial liabilities will be issued in the first half of 2010. At the time of drafting this memorandum the IASB's approach is to require financial liabilities to be measured at fair value or amortized cost. The IASB has tentatively decided that financial liabilities should be measured at amortized cost if they are not held for trading and do not have embedded derivative features that would require bifurcation under IAS 39. The IASB has also tentatively decided to retain the fair value option and to carry forward the eligibility conditions for the fair value option currently in IAS 39. The IASB's

- line of travel is that value changes attributable to 'own credit risk' would go to Other Comprehensive Income (OCI); there will be an offsetting entry to Profit & Loss. Amounts recognized in OCI will not be recycled.
8. Phases 2 and 3 of the IAS 39 replacement project deal with impairment and hedge accounting. An ED, “Amortised Cost and Impairment” was issued in November 2009 with an exposure period until June 30th 2010. The most significant proposal in the ED is to replace the incurred loss impairment model in IAS 39 with an expected loss model. The proposals require an entity to include the initial estimate of the expected credit losses for a financial asset in determining the effective interest rate. The initial estimate of the expected credit losses is to be allocated over the expected life of the financial asset. The proposed approach does not result in an impairment loss immediately after initial recognition, as a result of using amortized cost for subsequent measurement. Instead, under this proposed approach, impairment losses result only after initial recognition of the financial asset from an adverse change in the estimate of expected credit losses. The proposed approach does not include any indicators or triggering events as a threshold for estimates or changes in estimates. Currently the IASB Work Plan projects that an IFRS will be issued in the second half of 2010.
 9. Phase 3 of the IAS 39 replacement project addresses hedge accounting. The aim is to simplify the existing hedge accounting requirements in IAS 39. The IASB tentatively decided to replace fair value hedge accounting with an approach that is similar to cash flow hedge accounting and to further simplify the existing cash flow hedge accounting model to reduce complexity. The IASB is currently considering the new criterion for the purpose of determining risk components eligible for designation as hedged items. At the time of drafting this paper the IASB projects that an ED will be published in the second quarter of 2010 with an IFRS following in the last quarter of 2010.

Other IASB Projects with an Impact on IPSASs 28–30

10. This section of the paper considers briefly some other IASB projects that will have an impact, or have had an impact on IAS 32, IAS 39 and IFRS 7 and current timeframes for the issuance of EDs and completed amendments or IFRSs. Fuller technical detail on these projects is available on the IASB website (www.iasb.org). The projects discussed are:
 - Derecognition;
 - Financial Instruments with the Characteristics of Equity;
 - Fair Value Measurement;
 - Credit Risk in Liability Measurement;
 - Embedded Derivatives (Amendments to IAS 39 and IFRIC 9);
 - Annual Improvements with an impact on IAS 39;

- International Financial Reporting Interpretations Committee Interpretation (IFRIC) 19, “Extinguishing Financial Liabilities with Equity Instruments”; and
- Amendment to IAS 32 on Classification of Rights Issues

Derecognition

11. The IASB has a joint project with the US Financial Accounting Standards Board to improve the derecognition requirements and implementation guidance in IAS 39 for financial liabilities, improve the disclosure requirements in IFRS 7 and facilitate convergence with US GAAP. In March 2009 the IASB published an ED, “Derecognition,” which proposed principles for the derecognition of both financial assets and financial liabilities. The IASB is currently redeliberating proposals in the ED in the light of responses. In particular the approach to the derecognition of financial assets is likely to be significantly modified from that in the ED.

Financial Instruments with Characteristics of Equity

12. The IASB has a project to improve and simplify the financial reporting requirements in IAS 32 for financial instruments with the characteristics of equity. The project also has an impact on the measurement requirements in IAS 39. The project aims to develop a clearer distinction between equity and non-equity instruments and converge IFRS and US GAAP. The IASB issued a Discussion Paper, “Financial Instruments with Characteristics of Equity,” in February 2008. The issues addressed included the classification and reclassification of certain financial instruments, including convertible debt and puttable shares and a number of issues related to the initial and subsequent measurement of free standing equity instruments and hybrid instruments. There is a tentative intention to issue an ED in the second quarter of 2010.

Fair Value Measurement

13. The objective of the IASB project on fair value measurement is to establish a single source of guidance on fair value, to clarify the definition of fair value, to enhance disclosures about fair value and to increase convergence with US GAAP. If adopted, the proposals would replace fair value measurement guidance contained in individual IFRSs with a single, unified definition of fair value, as well as further authoritative guidance on the application of fair value measurement in inactive markets. It is not the intention of the project to extend the use of fair value where it is not currently required. The IASB issued an ED, “Fair Value Measurement” in May 2009 and is currently redeliberating certain issues. An IFRS is projected for the third quarter of 2010.
14. Although, as indicated above, the scope of the project is broad, its major impact will be on financial instruments. The IPSASB has tentatively considered initiating a broad-based project on fair value, but does not currently have such a project.

The measurement of fair value raises a number of public sector specific considerations, in particular whether the exit-based notion that the IASB appears to be moving towards is appropriate in many instances in the public sector. Because the IPSASB is not planning to consolidate guidance requirements and guidance relating to fair value, the approach to changes to requirements or guidance relating to fair value in the IASB's literature will have to be determined.

Credit Risk in Liability Measurement

15. The IASB issued a Discussion Paper, "Credit Risk in Liability Measurement" in June 2009. This was a staff paper developed by the IASB's Director of Research. It addressed the arguments for and against the inclusion of credit risk in the measurement of liabilities at initial recognition and subsequent to initial recognition. Any conclusions that the Board comes to in this project will inform other projects, including those dealing with fair value measurement and accounting for financial instruments.

Embedded Derivatives (Amendments to IAS 39 and IFRS 9)

16. In March 2009, the IASB issued "Embedded Derivatives (Amendments to IFRIC 9 and IAS 39)." The amendments clarify that on reclassification of a financial asset out of the "at fair value through profit or loss" category all embedded derivatives have to be assessed and, if necessary, separately accounted for in financial statements. A "Rules of the Road" analysis will be undertaken, as part of this project, to determine whether these amendments should be incorporated in IPSAS 29.

Annual Improvements with an Impact on IAS 39, IFRIC 9 and IFRIC 16

17. The Annual Improvements issued by the IASB in April 2009 included three amendments to IAS 39 and amendments to IFRIC 9 and IFRIC 16. As indicated above, two of these improvements are reflected in IPSAS 29. It is proposed that the other three amendments will be considered as part of the project to amend IPSASs 28-30 (see below paragraphs 20-25). The Annual Improvements to IPSASs project (Agenda Item 7) includes a cross-reference to the project to amend IPSASs 28-30 for the relevant amendments.
18. The Annual Improvements ED issued in August 2009 contained a proposed amendment to IFRS 7, dealing with the interaction between qualitative and quantitative disclosures about the nature and extent of risks arising from financial instruments. These improvements are scheduled to be issued in April 2010. Once finalized, Staff considers that these amendments should be considered as part of the project to amend IPSASs 28-30 (see below paragraphs 20-25).

International Financial Reporting Interpretation Committee Interpretation (IFRIC) 19,
“Extinguishing Financial Liabilities with Equity Instruments”

19. IFRIC 19, “Extinguishing Financial Liabilities with Equity Instruments” was issued in November 2009. IFRIC 19 deals with the accounting by an entity when the terms of a financial liability are renegotiated and result in the entity issuing equity instruments to a creditor to extinguish all or part of the financial liability. It does not address the accounting by the creditor. IFRIC 19 relates to IAS 32 and IAS 39. A “Rules of the Road” analysis will be undertaken, as part of this project, to determine whether this IFRIC should be included as an appendix to IPSAS 28 or IPSAS 29.

Amendment to IAS 32 on Classification of Rights Issues

20. IASB issued “Classification of Rights Issues (amendment to IAS 32)” in October 2009. The amendment addresses the accounting for rights issues (rights, options or warrants) that are denominated in a currency other than the functional currency of the issuer. Previously such rights issues were accounted for as derivative liabilities. However, the amendment requires that, provided certain conditions are met, such rights issues are classified as equity regardless of the currency in which the exercise price is denominated.

Options for Dealing with IASB Changes

21. Staff considers that there are three viable approaches for dealing with the replacement of IAS 39, outputs from the other IASB projects that may result or have resulted in changes to requirements in IAS 32, IAS 39, IFRS 7, IFRIC 9 and IFRIC 16 as at December 31st 2010 and the issuance of IFRIC 19.
22. **The first approach** is to address changes as they are approved and issued by the IASB on a continuous basis, including the changes to the requirements for financial assets in the first phase of IFRS 9 and other changes to IAS 32, IAS 39, IFRS 7 and related IFRICs.
23. **The second approach** is to defer all changes until the first three phases of IFRS 9 have been fully completed, and at this point to address IFRS 9 changes and other IASB amendments or pronouncements with a potential impact on IPSASs 28–30 or related IFRICs.
24. **The third approach** is to defer changes relating to IFRS 9 until all three phases have been completed, but consider the other changes to IFRSs and IFRICs as those changes are approved and issued by IASB.
25. Staff acknowledges the rationale for the third approach, particularly as some changes to IFRSs and IFRICs are already in place. The rationale for the third approach will be reinforced, if the completion of the IFRS 9 replacement project is protracted. On balance, however, Staff favors the second approach for a number of reasons including:

- Dealing with a number of changes in one ED is probably less resource intensive for constituents;
 - At a time when considerable Board time is being allocated to the Conceptual Framework it is questionable whether there is sufficient agenda time available in 2010 deal with financial instruments; and
 - Dealing with a number of IASB amendments together would provide a stable platform, which is likely to be beneficial for preparers and IPSAS adopters.
 - Staff notes that the European Commission is deferring the endorsement of the IFRS 9 changes until the 3 phases of IFRS 9 have been completed.
26. Staff also considers that it would be better to deal with improvements related to financial instruments from the IASB's 2009 and 2010 Annual Improvements publications as part of the larger project to amend IPSASs 28–30 rather than as part of IPSASB's own Annual Improvements to IPSASs project.

Action Requested

Members are asked **to confirm** the approach to dealing with IASB changes to pronouncements dealing with financial instruments, whereby a project will be commenced when the three phases of IFRS 9 have been completed, or **provide** alternative directions.