

# IPSAS Update

Financial instruments ED 62

## Task Force on Accounting Standards Meeting

Bekzod Rakhimov  
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**IPSAS**  
Benefits the UN

- The IPSASB issued IPSAS 28 *Financial Instruments: Presentation*, IPSAS 29 *Financial Instruments: Recognition and Measurement* and IPSAS 30 *Financial Instruments: Disclosures* in 2010. These IPSASs were converged with the equivalent IFRSs (2008) in issue at the time.
- Since then, the International Accounting Standards Board (IASB) has significantly revised its approach to the recognition and measurement of financial instruments through the issue of IFRS 9 *Financial Instruments*. Many of the revisions made in IFRS 9 respond to concerns raised after the global financial crisis about various aspects of accounting for financial instruments. These included the timeliness of information on credit losses and the use of fair value when measuring debt instruments, particularly an entity's own debt.

## The need for change

### IFRS 9 addressed a number of issues in applying financial instruments under IFRS

- Same issues existed under IPSAS 29

#### Difficult to:

- Classify assets
- Impairment model was reactive and
- Hedging was based on arbitrary rules

#### Process followed:

- Applied IPSASB process to align ED62 with IFRS 9
  - Included public sector specific modifications where appropriate
- Enables IPSASB to build on best practices in private sector financial reporting, while ensuring the unique features of the public sector are addressed

- Original IPSAS 28-30 project identified several items with public sector characteristics
- Includes guidance for public sector transactions:
  - Concessionary loans
  - Financial guarantees issued through non-exchange transactions

### **Project initiated in 2016 to update for IFRS9, *Financial Instruments***

- Phase 3 of the IASB's project to replace IAS 39, with IFRS9 completed in 2014
- IPSASB project initiated to maintain convergence with IFRS
- Main IFRS9 changes include:
  - Principle-based classification and measurement requirements for financial assets and liabilities
  - Introduction of the expected credit loss impairment model to replace the incurred loss model
  - More flexible hedge accounting principles

The decision to revise (and effectively replace) IPSAS 29, has resulted in changes in the following areas:

- The classification of financial assets for subsequent measurement. The process to classify instruments has been simplified and is based on how entities manage instruments, and the economic characteristics of the underlying cash flows of an instrument.
- The impairment model is no longer based only on historical evidence of credit losses. The revised approach, called an “expected loss” model, focuses on both historical and forward looking data that provides entities with information about the credit losses that are likely over the life of the instrument.
- The hedge accounting requirements are more flexible. There is better flexibility of what may qualify as a hedged item which may be to the benefit of entities that are not financial institutions. The hedge effectiveness requirements are also less onerous.

The IPSASB plans to complete the revisions to its IPSASs on *Financial Instruments in Quarter 3 of 2018*.

# Specific matters to comment on as requested by IPSASB

## **Specific matter for comment 1**

Consistent with the relief provided in IFRS 9, the IPSASB has agreed in [draft] IPSAS [X] (ED 62) to allow an option for entities to continue to apply the IPSAS 29 hedging requirements. Do you agree with the IPSASB's proposal?

## **Specific matter for comment 2**

The IPSASB recognizes that transition to the new standard [draft] IPSAS [X] (ED 62) may present implementation challenges as a result of the number of significant changes proposed. Therefore the IPSASB intends to provide a 3 year implementation period until [draft] IPSAS [X] (ED 62) is effective (early adoption will be permitted). Do you agree with the proposed 3 year implementation period before [draft] IPSAS [X] (ED 62) becomes mandatory? Please explain.

## **Specific matter for comment 3**

Do you agree with the proposed transition requirements in paragraph 153-180, consistent with those provided in IFRS 9? If not, what specific changes do you recommend and why?

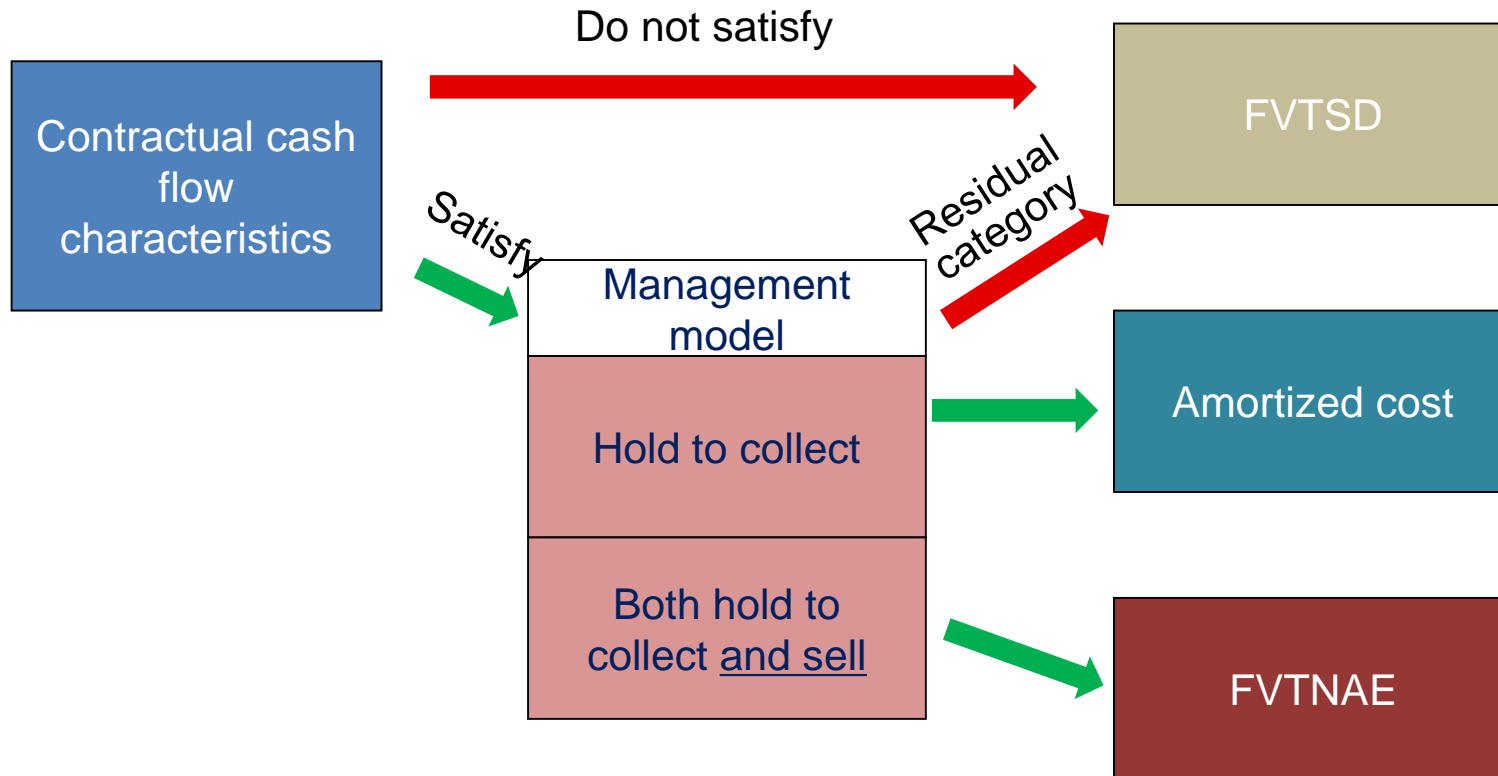
## **Other matters**

As with any other Exposure Draft, comment on any other matter would be welcomed. Comment is most helpful if reference is made to a specific paragraph or group of paragraphs in your response.

## ED62: 3 management models

- **Held to collect** contractual cash flows (amortized cost)
- **FVTSD**: Fair Value Through Surplus or Deficit
- **Mixed model**: FVTNAE: Fair value Through Net Assets / Equity

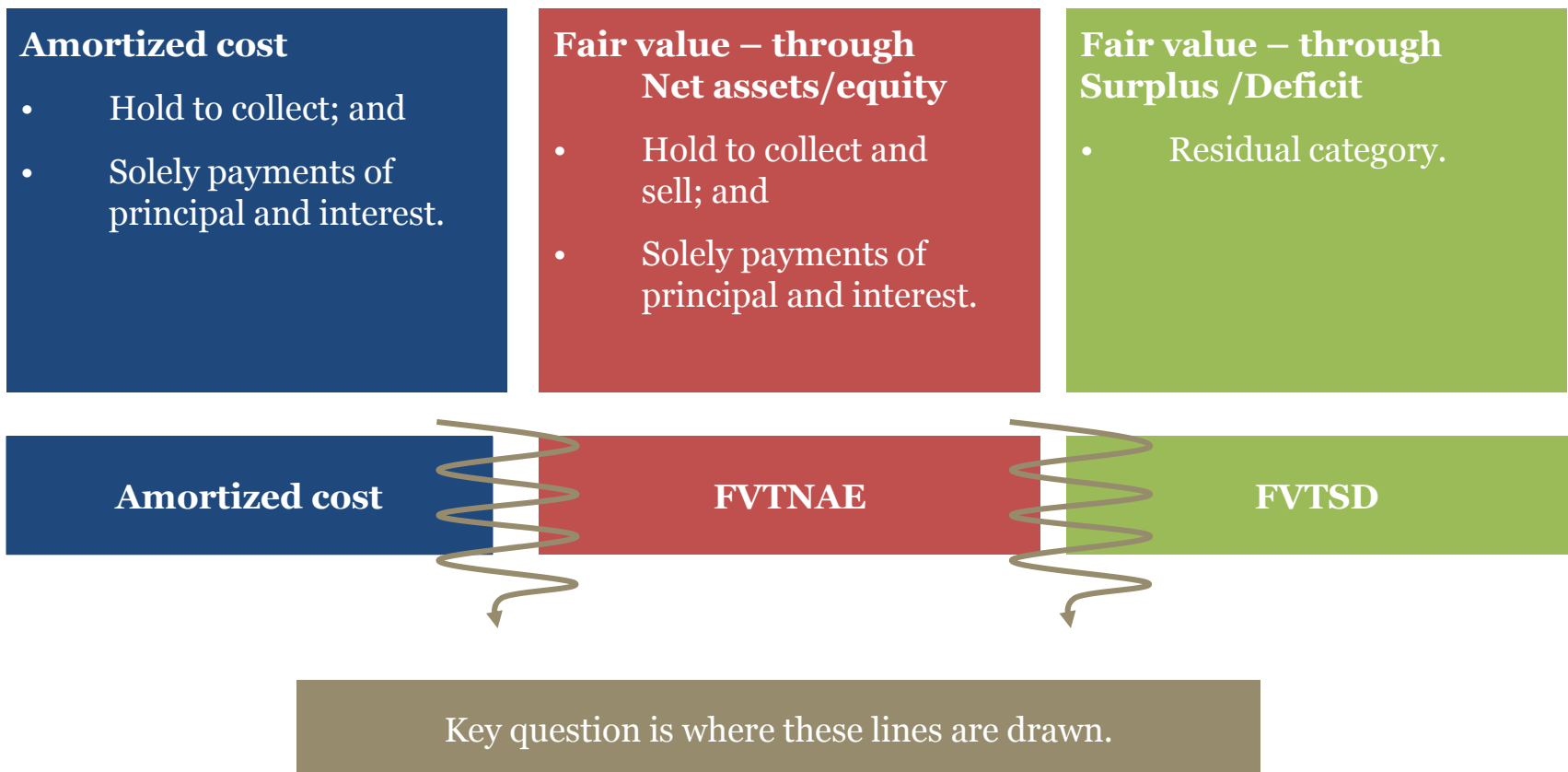
Management model is decided by management



Reclassification applies to all management models



## Overview of three categories





Amortized cost : a unique objective “hold to collect”

- ❑ Significant sales must be infrequent (e.g. unanticipated/stress case)
- ❑ Frequent sales must be insignificant both individually and in aggregate
- ❑ Some exceptions: e.g. sales due to deterioration in credit quality in line with a documented investment policy

An entity should not consider every ‘what if’ or worse-case scenario

Unanticipated sales :

- ❑ No restatement of prior period financial statements; nor change in the classification of the remaining financial assets in the management model
- ❑ As long as the entity considered all relevant and objective information for initial classification

Liquidity portfolios :

- ❑ The portion held for extreme stress scenarios may be classified as amortized cost
- ❑ But significant or frequent sales are incompatible with amortized cost (even if the sales are imposed by regulators to demonstrate liquidity)

Mixed management model « originate to hold and / or distribute »

- ❑ Granularity of the analysis is key (identification of sub-portfolios)



FVTNAE : a mixed objective “hold to collect AND sell”

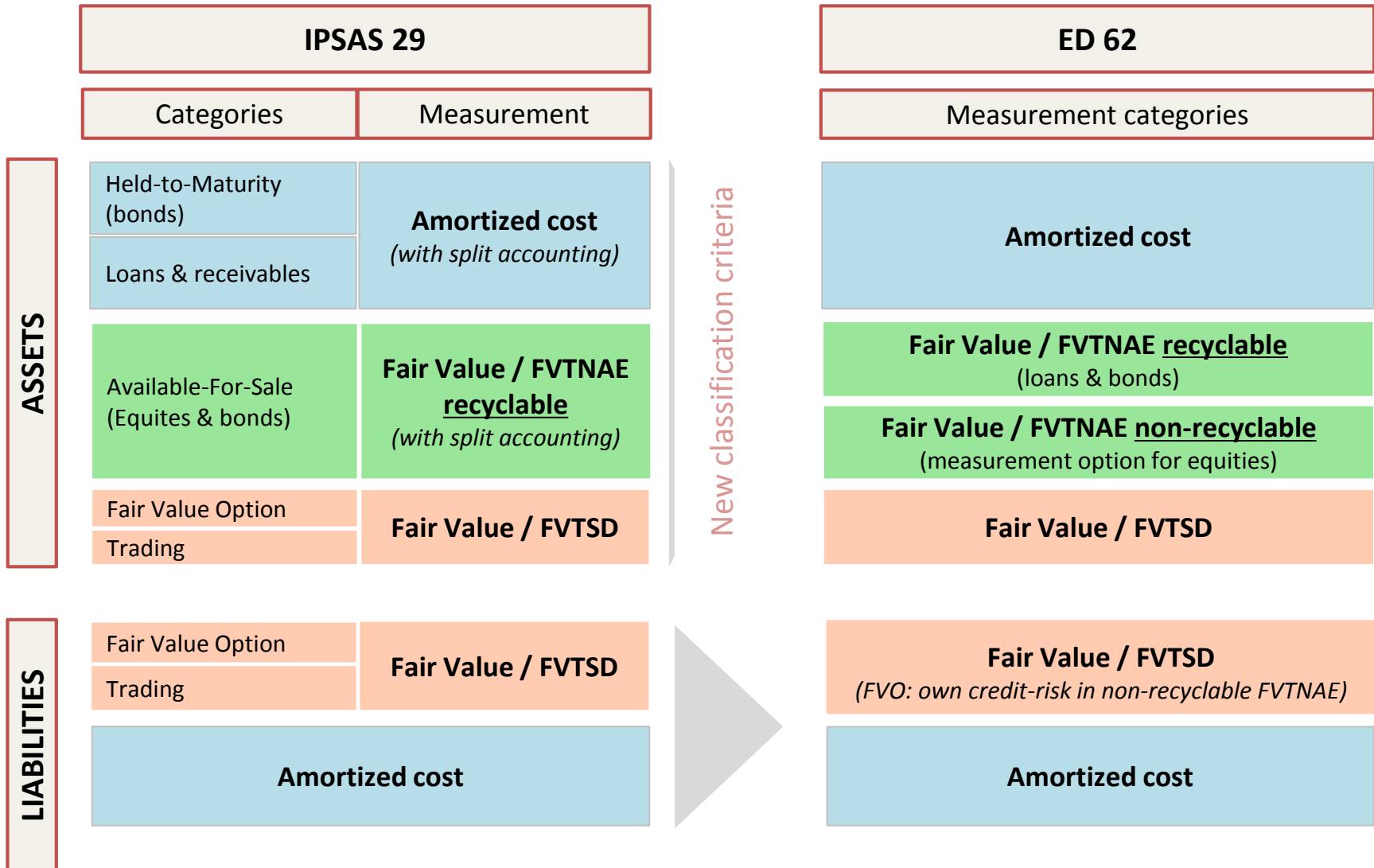
- No threshold for frequency or amount of sales
- Key Performance Indicators for FVTNAE are contractual interest yield, impairment charges and fair value changes
- Examples :
  - A bank holds financial assets to meet its everyday liquidity needs. The bank typically holds some financial assets to collect contractual cash flows and sells others to reinvest
  - An insurer holds financial assets in order to fund insurance contract liabilities. The insurer also undertakes significant buying and selling activity to rebalance the portfolio of financial assets

Trading assets + assets managed and assessed at FV should be classified at FVTSD

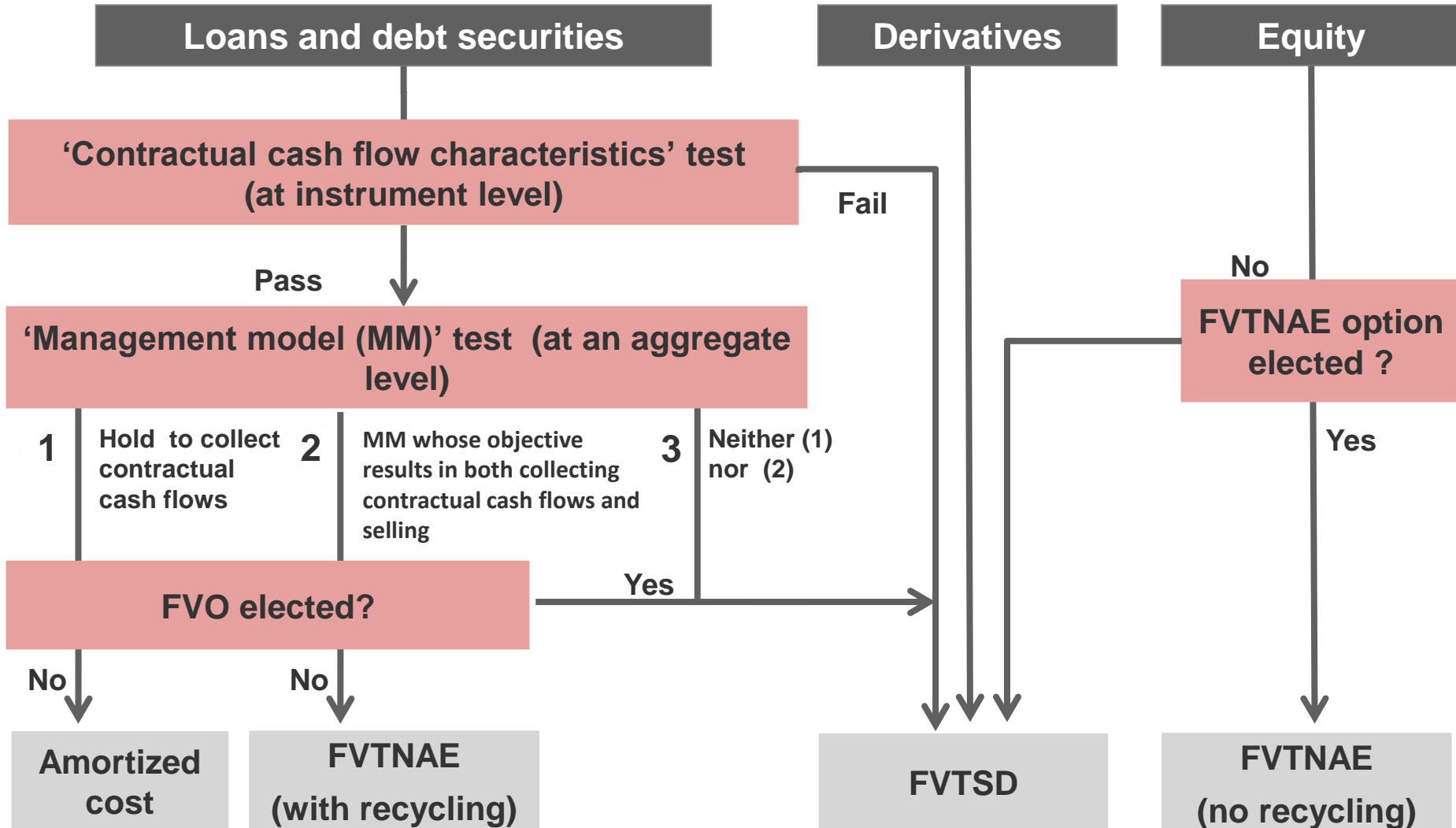
Reclassifications are prohibited

- Unless fundamental change in Management Model (very infrequent)
- That would generally be the case only when the entity has acquired or disposed of a business line.

# Classification & measurement: overview



# ED62 –criteria for classification and measurement



Equities under ED62: default is FVTSD

Option to record fair value changes through Net assets/equity, with no recycling of gain/loss on disposal

- Irrevocable choice on an instrument by instrument basis at initial recognition, if not held for trading
- Only dividends are recorded in surplus or deficit
- Extensive disclosures

AFS Impairment rules – no longer relevant ('significant and prolonged' goes away)

# Debt instrument – illustrative example 1 (simplified fact pattern)

UN entity A purchases a 5 year corporate bond with a fixed interest rate of 3%. The bond was purchased as part of the funds set aside to finance the construction of a new building in 5 years. It intends to hold the instrument to maturity and collect on the cash flows. The instrument was previously held as part of the HTM portfolio under IPSAS 29.

SPPI Test: Pass

Management model: Hold to collect contractual cash flows

ED 62 classification: Amortized cost

# Debt instrument – illustrative example 2 (simplified fact pattern)

UN entity B purchases a 5 year corporate bond with a variable interest rate based on market rates. The bond was purchased as part of the funding set aside to finance ASHI liabilities. It intends to hold the instrument to maturity and collect on the cash flows, but may sell as part of periodic rebalancing of the portfolio to better match estimated timing and amount of future ASHI payments. The instrument was previously classified as AFS under IPSAS 29.

SPPI Test: Pass

Management model: Hold to collect and sell

ED 62 classification: FVTNAE (Debt)



# Debt instrument – illustrative example 3 (simplified fact pattern)

UN entity C purchases a 5 year corporate bond, interest rate variable based on market rates (same instrument from example 2).

Converts into a fixed number of equity instruments of the issuer

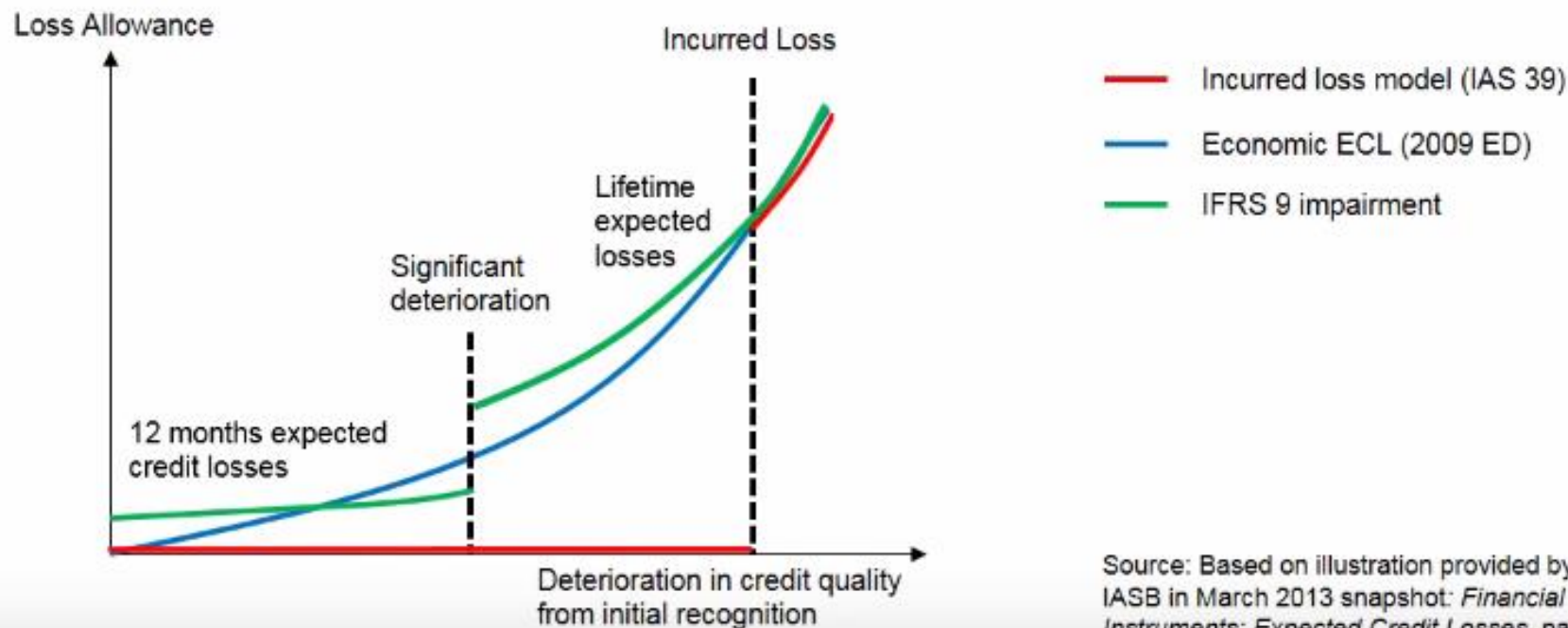
SPPI Test: Fail

Management model: ? (but not relevant, as step 1 is FAIL, so designation goes to FVTSD)

ED 62 classification: FVTSD

- Loss recognition based on objective evidence
- Assets held at Cost / Amortized cost
  - Impairment = carrying amount – PV of estimated future cash flows
  - Recognized in surplus / deficit
  - Reversals allowed
- AFS
  - Impairment = cumulative loss recognized in net assets / equity
  - Reclass of loss from net assets / equity to surplus / deficit
  - Reversible for debt and non reversible for equity

## IFRS 9: Impairment – the Stepped Profile



Change in credit quality since initial recognition



## Recognition of expected credit losses

12 month expected  
credit losses

Lifetime expected  
credit losses

Lifetime expected  
credit losses

## Interest revenue

Effective interest on gross carrying  
amount

Effective interest on gross carrying  
amount

Effective interest on amortised  
cost carrying amount  
(i.e. net of credit allowance)

**Stage 1**

**Stage 2**

**Stage 3**

*Performing*  
(Initial recognition\*)

*Underperforming*  
(Assets with significant  
increase in credit risk since  
initial recognition\*)

*Non-performing*  
(Credit impaired assets)

\*Except for purchased or originated credit impaired assets

### Definitions

<b>12-month expected credit losses</b>	Are a <i>portion</i> of the lifetime <i>expected credit losses</i> and represent the amount of <i>expected credit losses</i> that result from default events that are possible within 12 months after the reporting date.
<b>Lifetime expected credit losses</b>	The <i>expected credit losses</i> that result from all possible default events over the life of the financial instrument.
<b>Credit loss</b>	The difference between all principal and interest cash flows that are due to an entity in accordance with the contract and all the cash flows the entity expects to receive discounted at the original EIR.
<b>Expected credit losses</b>	The weighted average of credit losses, or in other words probability weighted estimate of credit losses

# Example 1 of measurement under ECL

Entity B originates a 10 year loan for \$1M. Interest paid annually. Loan's coupon and EIR are 5%.

**Scenario A:** No significant increase in credit risk since inception: Entity B estimates:

- The loan has a 12 months probability of default (PD) of 0.5% and
- The estimate of impact of loss given default (LGD) is 25%, and would occur in 12 months time if the loan were to default

**Under IPSAS 29:** No loss at inception. Impairment only recognized if and when loss event occurs e.g. \$250,000 (25% x 1M) in 12 months time if estimates are accurate

**Under ED 62:** 12 month ECL at inception

Estimated cash flows receivable x PD x LGD, discounted at original EIR

=  $(1M + 50,000) \times 0.5\% \times 25\% / 1.05 = \$1,250 \Rightarrow$  continue to adjust and monitor for significant increase in credit risk

# Example 2 of measurement under ECL

Entity B originates a 10 year loan for \$1M. Interest paid annually. Loan's coupon and EIR are 5%.

**Scenario B:** Significant increase in credit risk since inception: Entity B estimates:

- The loan has lifetime probability of default (PD) of 20% and
- The estimate of impact of loss given default (LGD) is 25%, and would occur on average in 24 months time if the loan were to default

**Under IPSAS 29:** No loss at inception. Impairment only recognized if and when loss event occurs e.g. \$250,000 (25% x 1M) after 24 months when incurred

**Under ED 62:** Lifetime ECL

Estimated cash flows receivable x PD x LGD, discounted at original EIR

=  $(1M + 50,000) \times 20\% \times 25\% / 1.05^2 = \$47,619$  => as soon as significant increase in credit occurs. Continue to adjust based on updated facts and circumstances.

**Trade A/R from transactions with other entities amount to CU10 million, these can be provisioned using the following example matrix:**

	Lifetime expected credit loss rate (A)	Gross carrying amount (B)	Forward looking adjustment (C) (***)	Lifetime expected credit loss allowance (A x B x C)
<b>Current</b>	1%	CU 5M	0.99	\$49,500
<b>1-60 days past due</b>	2%	CU 3M	0.99	\$59,400
<b>61-180 days past due</b>	5%	CU 1M	0.98	\$49,000
<b>More than 180 days past due</b>	10%	CU 1M	0.98	\$98,000
				<b>\$255,900</b>

\*\*\* - Forward looking adjustment is for expected future events to occur (forward looking macroeconomic analysis that would increase/ decrease probability of default – e.g. increase in unemployment, growth of economy, etc. – whichever factors might influence the collectability of receivables that would be considered in modeling)



Financial assets with low credit risk (optional) – e.g. investment grade financial instruments

More than 30 days past due rebuttable presumption – student loans past 30 days due to admin oversight (so that it doesn't have to be analyzed on individual student loan basis)

Change in 12 month risk of a default as approximation for change in lifetime risk