ICAEW REPRESENTATION 196/16

Consultation Paper: Public Sector Specific Financial Instruments

ICAEW welcomes the opportunity to comment on the *Public Sector Specific Financial Instruments* consultation published by the International Public Sector Accounting Standards Board (IPSASB) in July 2016, a copy of which is available from this link.

This response of 23 December 2016 has been prepared on behalf of ICAEW by its Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the Faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. Comments on public sector financial reporting are prepared with the assistance of the Faculty's Public Sector Development Committee. The Faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

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MAJOR POINTS

Support for the consultation paper

1. We welcome the opportunity to contribute to this consultation on public sector specific financial instruments. We support IPSASB's broader strategy of focusing on public sector specific accounting standards since that is where there is a sizable gap in accounting standard literature. Furthermore, it is in the public interest that more governments adopt internationally recognised accounting standards and no doubt the attractiveness to adopt IPSASs will increase with a wider coverage.

2. We have a number of specific comments in response to the questions posed by IPSASB. We preface our responses to those questions with some observations on future developments and measurement issues.

Future developments

3. We have come across a number of standards that IPSASB are creating that would, had they been under IFRS, make use of Other Comprehensive Income (OCI). Financial instruments are an obvious example but employee benefits and social benefits accounting standards will further underline the need for IPSAS to include this category of income and expense. We encourage IPSASB to remain aligned with IFRS as much as possible, which means that existing standards should be reviewed and updated more frequently than is currently the case. The lack of OCI in IPSAS is just one example of the misalignment.

Measurement basis will divide opinion

4. ICAEW published *Measurement in Financial Reporting* in 2006 as part of the thought leadership series *Information for Better Markets Initiative*. The report looks at a number of different measurement basis and presents a well-rounded discussion on the topic. A copy of this report can be found here and we commend this report to IPSASB. One of the observations made in the report is that the debate on measurement basis is very subjective and various stakeholders with different needs will have opposing views. The IPSASB, as a standard setter, should clearly spell out the reasoning behind any final decisions in the basis for conclusions.

5. Unlike consultations issued by the IASB, where there tends to be is a large investor community responding, the consultations by IPSASB do not generally have the same diversity of respondents. This probably reflects the relatively narrow range of users of government accounts at present. Government accounts should enable those responsible to be held to account, enable decision-making and provide greater transparency. Preparers however, may not always share these objectives and it is in the public interest that IPSASB genuinely consider the information needs of all stakeholders, including potentially the general public, even if they are not currently regular users of government accounts.

Clarifications of thought process

6. A number of definitions are proposed in this consultation paper (CP). Whilst links to their origin have been made in the appendices, it is not obvious why this CP proposes to deviate from their statistical framework origins. It would be useful if future consultations would make this more explicit, since alignment with statistical frameworks, where appropriate, is desirable.

7. Even slight deviations in wording may lead some preparers to interpret the definitions differently compared to the statistical framework, leading to potentially different outcomes.

RESPONSES TO IPSASB QUESTIONS

Preliminary View 1:

Definitions are as follows:

a) Monetary authority is the entity or entities, including the central bank or a department(s) of the central (national) government, which carry out operations usually attributed to the central bank.

b) Reserve assets are those external assets held by monetary authorities that are readily available for balance of payments financing needs, intervention in the currency markets to affect exchange rates and maintaining confidence in the currency and the economy.

Do you agree with the IPSASB's Preliminary View?

8. The above definition of monetary authority is a departure from the definition provided by Balance of Payments and International Investment Position Manual – Sixth Edition (BPM6). Paragraph 6.66 of BPM6, as noted in paragraph A10 of the CP, provides a general definition of reserve assets as follows:

   The functional concept of monetary authorities is essential for defining reserve assets. Monetary authorities encompass the central bank (which subsumes other institutional units included in the central bank subsector, such as the currency board) and certain operations usually attributed to the central bank but sometimes carried out by other government institutions or commercial banks, such as government-owned commercial banks.

9. Likewise, paragraph A9 in the CP provides the BPM6 definition of reserve assets. The definition of reserve assets per BPM6 paragraph 6.64 is:

   Reserve assets are those external assets that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for intervention in exchange markets to affect the currency exchange rate, and for other related purposes (such as maintaining confidence in the currency and the economy, and serving as a basis for foreign borrowing).

10. We are not sure why IPSASB does not simply use the same definitions as per BPM6? The differences are not large but nevertheless there is a risk that these differences might lead some people, in our view, mistakenly, to believe that there is a difference in substance.

11. As noted above, the CP has made reference to the definitions in BPM6 in paragraphs A9 and A10, yet these paragraphs don't actually make it crystal clear that BPM6 paragraphs 6.64 and 6.64 are definitions rather than just a description. IPSASB should, if they chose to depart from statistical frameworks, clearly spell out the specific reasons for any departures.

Preliminary View 2:

Definition is as follows:

Currency in Circulation is physical notes and coins with fixed and determinable values that are legal tender issued by, or on behalf of the monetary authority, that is, either that of an individual economy or, in a currency union to which the economy belongs.

Do you agree with the IPSASB's Preliminary View?

12. The definition proposed in this CP is an amalgamation of the BPM6 definitions of “domestic currency” (paragraph 3.95 of BPM6 and noted in paragraph A3 of the CP) and “currency” (paragraph 5.36 of BPM6 and noted in paragraph A4 of the CP):

    Domestic currency is that which is legal tender in the economy and issued by the monetary authority for that economy; that is, either that of an individual economy or, in a currency union, that of the common currency area to which the economy belongs.

    Currency consists of notes and coins that are of fixed nominal values and are issued or authorized by central banks or governments.

13. Whilst we would have preferred a closer alignment with the wording in BPM6, we accept the proposed definition.

Preliminary View 3:

Notes and coins (currency) derive value because they are legal tender and accepted as a medium of exchange and therefore serve the same purpose and function in the economy. As the purpose and function of notes and coins is the same, the IPSASB’s view is the accounting treatment should be consistent for both (as noted in paragraph 3.12), with the recognition of a liability when issued.

Do you agree with the IPSASB’s Preliminary View?

14. We agree with the preliminary view on notes and coins above.

Specific Matter for Comment 1:

When the monetary authority assesses that a present obligation does not exist as a result of the issuance of currency, because of the absence of a legal or non-legally binding obligation (approach 1), it results in the recognition of revenue (approach 2), please explain your view and your thoughts on what is the appropriate financial statement in which to recognize revenue:

(i) Statement of financial performance; or

(ii) Statement of net assets/equity?

Please provide the reasons for your support of your preferred option, including the conceptual merits and weaknesses; the extent it addresses the objectives of financial reporting and how it provides useful information to users.

15. We consider that the issuance of currency will, in most cases, lead to a legal or non-legally binding obligation and find it difficult to imagine circumstances where this might not be the case.

16. Given that this CP has devoted quite a lot of space to this debate, we assume that IPSASB have been made aware of some jurisdictions that do not recognise a liability. Perhaps IPSASB could provide some examples of jurisdictions that do not recognise a liability upon issuance of currency? Whilst the examples of paragraph 3.41 are interesting and useful in thinking about recognition, adding empirical evidence would be welcome.

17. Accounting standard setters should be mindful of the importance of setting standards that meet the needs for the majority of their stakeholders, whilst avoiding undue complexity. Accounting standards should not be designed to cater for every eventuality that may exist.

They should provide clear requirements for common types of transaction, including principles that may be applied to more unusual transactions and circumstances.

18. At this stage of the consultation process we are sceptical that a future standard on currency in circulation should provide for the eventuality that no obligations exist. When preparers face local circumstances not envisaged by the standard, they should apply their judgement in arriving at a solution that is true and fair and provides users with the information they require.

Preliminary View 4:

Definitions are as follows:

(a) Monetary gold is tangible gold held by monetary authorities as reserve assets.

(b) Tangible gold is physical gold that has a minimum purity of 995 parts per 1000.

Do you agree with the IPSASB's Preliminary View?

19. The definition of monetary gold is in paragraph 6.78 of BPM6 and noted in paragraph A7 of the CP:

    Monetary gold is gold to which the monetary authorities (or others who are subject to the effective control of the monetary authorities) have title and is held as reserve assets.

    BPM6 goes on to say (but is not part of the definition): *It consists of gold bullion (including gold coins, ingots, bars with a purity of at least 995/1,000, and gold bullion held in allocated gold accounts, regardless of the location of the account) and unallocated gold accounts with non-residents that give title to claim the delivery of gold. Gold bullion is usually traded on organized markets or through bilateral arrangements between central banks. To qualify as reserve assets, gold accounts must be readily available upon demand to the monetary authorities.*

20. This CP is proposing definitions that depart from BPM6 without apparent good reason. We feel that the definitions in BPM6 are more robust since it refers to having title to the gold.

Specific Matter for Comment 2:

Should entities have the option to designate a measurement basis, based on their intentions in holding monetary gold assets (as noted in paragraphs 4.5-4.6)?

Please provide the reasons for your support for or against allowing an option to designate a measurement basis based on intentions.

21. Monetary gold is a reserve asset as recognised in the recommended definition in the CP. Reserve assets are assets that are readily available for balance of payments financing needs, interventions in the currency markets to affect exchange rates and maintaining confidence in both currency and wider economy. A key element of reserve assets is to convey the strength and flexibility of a government. We firmly believe that fair value provides the most objective measure of a government's reserve assets and that entities should not have the option to designate a measurement basis. The fair value of gold will be the market value given the open and active market that exists.

22. ICAEW issued *Measurement in Financial Reporting* as part of the thought leadership series on *Information for Better Markets Initiative.* The publication explores different measurement basis and some wider issues. It notes that some financial analysts regard fair value as the only information relevant for financial decision-making.

23. Some argue that market value introduces unnecessary volatility in the statement of financial performance. In our view this ignores economic reality. Monetary authorities hold reserve assets to provide stability and liquidity for the functioning of financial markets. Users of their financial statements would want to see any rises and falls in monetary gold values to measure the performance of the monetary authority but to also assess the financial capacity. The financial capacity to intervene in global markets can, in our opinion, only be measured by using current values.

24. The two main intentions of holding monetary gold as described in paragraph 4.5 would both benefit from having market value as the measurement basis. Intention two, which advocates historic cost, states that monetary gold is held for indeterminate period of time because it provides confidence in the monetary authority's financial strength. The monetary authority should be made to convey that strength in real terms, i.e. on current values rather than some arbitrary historic value when the gold price might have been very high. That could be misleading.

25. The argument that some monetary authorities may be restricted or prohibited from selling gold is not one which should influence this debate given that governments are uniquely placed to change the laws if deemed necessary. There are many examples where a change in law took place to circumvent the long-standing status quo.

26. The fair value of monetary gold is easy to obtain given the open and active gold bullion market and will not face the same measurement difficulties that apply to some non-quoted financial instruments. Thus fair value will be as reliable as historic cost, perhaps more so if records have not been maintained on the purchase of the gold. Furthermore, comparability will naturally be increased by the removal of the option to designate measurement basis.

Specific Matter for Comment 3:

Please describe under what circumstances it would be appropriate to measure monetary gold assets at either:

i. Market value; or

ii. Historical cost?

Please provide reasons for your views, including the conceptual merits and weaknesses of each measurement basis; the extent to which each addresses the objectives of financial reporting; and how each provides useful information.

If you support measurement based on intentions as discussed in SMC 4-1, please indicate your views about an appropriate measurement basis for each intention for which monetary authorities may hold monetary gold, as discussed in paragraph 4.5 (i.e., intended to be held for its contribution to financial capacity because of its ability to be sold in the global liquid gold trading markets, or intended to be held for an indeterminate period of time).

27. As previous debates on measurement basis have demonstrated, it will most likely be the case that each measurement basis will have its supporters with often strongly entrenched views. However, as noted below and in response to SMC 2, we are in favour of applying market value to monetary gold without the option to choose measurement basis.

28. Monetary gold is held for its ability to store value and should be held at market value to reflect that. Gold at market value would provide users with the most relevant information since it would provide information on the financial capacity of the monetary authority. Furthermore, the market value of gold, being based on current values, would be easily understood by users. We

also believe that market value would be most suitable for accountability and decision-making purposes.

29. Given the role reserve assets play, we are of the opinion that these assets are effectively *held for trading*, otherwise they could not play a stabilising role. Assets that are held for trading are measured at fair value and we would not see a reason why monetary gold assets should be treated differently.

30. Historic cost accounting does not recognise unrealised gains and losses and is often seen as a more conservative measurement basis. Whilst this is no doubt beneficial for some assets, it is not so for reserve assets which should not be undervalued or overvalued if they are to play a stabilising role in the economy. Historic cost would have the potential to send out wrong signals and mislead the market. Lastly, it is unlikely that internal management decisions on gold would be made based on historic costs; market value would match the information that management uses.

Preliminary View 5:

Definitions are as follows:

(a) The IMF Quota Subscription is the amount equal to the assigned quota, payable by the member on joining the IMF, and as adjusted subsequently.

(b) SDR Holdings are International reserve assets created by the IMF and allocated to members to supplement reserves.

(c) SDR Allocations are obligations which arise through IMF member's participation in the SDR Department and that are related to the allocation of SDR holdings.

Do you agree with the IPSASB's Preliminary View – Chapter 5-1?

31. The CP does not make it clear that the reason for the separate classification of SDRs as either assets (SDR Holdings) and liabilities (SDR Allocations) is that the IMF account for them separately and the BPM6 requires that holdings and allocations are shown gross rather than net (in paragraph 5.35 of BPM6 and noted in paragraph A14 of the CP). This point should be highlighted given that SDR Holdings and SDR Allocations are inter-related.

32. BPM6 defines SDRs but only describes SDR holdings and SDR allocations. The SDR definition is in paragraph 5.34 of BPM6 and noted in paragraph A13 of the CP:

    SDRs are international reserve assets created by the IMF and allocated to members to supplement existing official reserves.

    The last sentence of this paragraph goes on to say (but not as a part of the definition) that "SDR holdings represent unconditional rights to obtain foreign exchange or other reserve assets from other IMF members." We are of the opinion that the definition of SDR Holdings would be more complete if it included this explanation as it specifically relates to the SDR that is an asset. A revised definition is proposed below (in mark-up):

    "SDR Holdings are international ~~International~~ reserve assets created by the IMF and allocated to members to supplement existing official reserves and represent unconditional rights to obtain foreign exchange or other reserve assets from other IMF members."

33. We agree with the other definitions but we believe that an explanation as to how these definitions were derived (based on statistical frameworks) would be useful.

Preliminary View 6:

The IPSASB view is that:

(a) The IMF Quota Subscription satisfies the Conceptual Framework definition of an asset and should be recognized, with initial measurement at historical cost. Subsequent measurement may be at historical cost when the translated value of the quota subscription equals the cumulative resources contributed to the IMF, when it does not it should be measured at net selling price.

(b) SDR holdings satisfy the Conceptual Framework definition of an asset and should be recognized, with measurement at market value.

(c) SDR allocations satisfy the Conceptual Framework definition of a liability and should be recognized, with measurement at market value.

Do you agree with the IPSASB's Preliminary View – Chapter 5-2?

34. We agree with the preliminary view.

35. We agree with the consultation paper views on using net selling price (equivalent to fair value as per page 46 of the CP) when the translated value of the quota subscription does not equal the cumulative resources contributed. As per paragraph 5.10, changes in a member's currency due to FX movements results in adjusting contributions to or from the IMF. Depending on the timing of the adjusting contributions, it will be more likely that the translated value of the quota subscription will not equal the cumulative resources contributed to the IMF. Thus, we anticipate the net selling price playing a more prominent role. Should the quota be equal to contributions then historical cost and fair value are in fact materially the same.

36. We agree with the preliminary view that SDR Holdings are assets and SDR Allocations liabilities. Furthermore, we also agree that SDR Holdings and Allocations are monetary items and that fair value is the most appropriate measurement basis. In the UK, these are measured at fair value through profit and loss.