PUBLIC SECTOR
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Mr. John Stanford
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Re: PSAB Staff Comments on Consultation Paper "Public Sector Specific Financial Instruments"

Thank you for the opportunity to comment. We appreciate that Public Sector Specific Financial Instruments is an important and difficult topic facing public sector accounting today.

The Canadian Public Sector Accounting Board (PSAB) is currently evaluating its financial instruments framework to identify areas of improvement. One such area is the lack of guidance relating to financial instruments specific to the public sector, such as those addressed in this Consultation Paper. PSAB staff appreciate the uniqueness of these instruments and have followed the IPSASB's project with interest. This guidance may ultimately represent a topic for which Canadian convergence would easily fill in a gap in Canadian public sector GAAP.

Broadly PSAB staff support the principles proposed by the IPSASB in this Consultation Paper. However, we note the possibility that principles developed in this Consultation Paper may need to be revised on completion of IPSASBs IFRS 9 convergence project. An iterative development of principles in these two projects could mitigate the possibility that different principles would be issued for issues of common substance. And it would reduce the likelihood of onerous work for IPSASB stakeholders in adopting public sector specific financial instrument guidance that may be amended as a result of the IFRS 9 convergence project. Consequently, we recommend that the IPSASB consider the impact of the revised suite of financial instruments standards on the principles developed in this Consultation Paper when the exposure draft is drafted.

We would also like to bring a scope and related terminology question to your attention. This Consultation Paper includes guidance in relation to accounting for monetary gold. As noted in the Consultation Paper, monetary gold does not meet the definition of a financial instrument. Including guidance for an instrument that is not within the scope of the broader financial instruments suite of standards is counterintuitive. Perhaps the scope of the Consultation Paper is

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broader than public sector financial instruments as that term is defined in IPSASBs existing framework? Perhaps a revised title, “Reserve Instruments and Currency in Circulation” might be more precise?

Overall, PSAB staff are supportive of the IPSASB moving ahead with an exposure draft based on the proposals in the Consultation Paper, with the caution that those proposals would need to be updated for areas of commonality or overlap with developments in the IFRS 9 convergence project. The options in the paper are well presented and clear.

Our feedback in relation to Specific Matters and Preliminary Views are set out in the Appendix to this letter. Please note that this letter and those comments represent the views of PSAB staff and not those of PSAB.

Thank you again for the opportunity to provide you with input on this Consultation Paper. We hope you find our comments helpful.

Sincerely,

Dave Warren

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APPENDIX

Preliminary View – Chapter 2 (following paragraph 2.9)

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 – Chapter 2?

Yes, PSAB staff agree with IPSASB's Preliminary View – Chapter 2.

Preliminary View – Chapter 3-1 (following paragraph 3.10)

Definition is as follows:

(a) 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 – Chapter 3-1?

Yes, PSAB staff agree with IPSASB's Preliminary View – Chapter 3-1.

Preliminary View – Chapter 3-2 (following paragraph 3.30)

(a) 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 – Chapter 3-2?

PSAB staff agree with the view that notes and coins derive value because they are legal tender and accepted as a medium of exchange and serve the same purpose and function in the economy. Staff also believe instruments with the same characteristics should be accounted for consistently. However, purpose and function are not the only characteristics of coins and notes. More importantly the purpose and function detailed in the Consultation Paper – notes and coins derive their value because they are legal tender and accepted as a medium of exchange – are irrelevant when evaluating whether a liability is recognized.

Paragraph 5.14 of IPSASBs conceptual framework defines a liability as *a present obligation of the entity for an outflow of resources that results from a past event.*

Simply put, the act of issuing currency does not result in a liability based on the conceptual framework definition of liability. No obligation exists to give up future economic resources. Only when the monetary authority is required to replace the currency in circulation – either by law or by way of constructive obligation – are the liability criteria satisfied. The requirement to replace currency in circulation is independent of the purpose and function detailed in the Consultation Paper. Many examples exist where the purpose and function of instruments are the same but an obligation is created in only one scenario (for example, securitization of similar instruments can result in a liability depending on the specific characteristics of a transaction). It is reasonable to expect the characteristics of notes and coins in some jurisdictions to be dissimilar enough to create a liability for one and not the other. In fact, it is even possible that a liability is only created for a portion of notes in circulation (for example, the monetary authority is only required to replace notes in excess of 20 currency units).

In the Canadian environment, the Bank of Canada Act stipulates notes in circulation are a first charge against the monetary authority. A separate act – the Currency Act – governs coins in circulation, for which no stipulation exists.

PSAB staff are of the view the purpose and function of notes and coins are the same and accounting principles should be applied consistently to each instrument. However, this does not mean the Consultation Paper should prescribe an accounting outcome. The Consultation Paper should develop principles that can be applied based on the facts and circumstances associated with each issuance of currency. When these instruments have the same characteristics – as PSAB staff expect in many cases for notes and coins – the accounting should be consistent.

Furthermore, requiring a liability to be recognized for currency in circulation appears to be a departure from IPSASB's principles based approach. The IPSASB has existing financial instrument guidance that should be applied to determine if a financial liability is recognized. Since IPSAS 28 already defines a financial liability[1], the Consultation Paper is repeating this guidance by applying it to a specific transaction – currency in circulation.

PSAB staff is of the view the obligation created by issuing currency is not unique. No additional financial instrument guidance is required. However, taken as a whole, PSAB staff support the development of guidance in determining whether the credit entry in a currency in circulation transaction is presented as revenue or as a liability.

Specific Matters for Comment – Chapter 3-1 (following paragraph 3.43)

(a) 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 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 if addressed of the objectives of financial reporting and how it provides useful information to users.

[1] IPSAS 28.9 indicates a financial liability is a contractual obligation to deliver cash or another financial asset, or to exchange financial liabilities at potentially unfavorable terms, or a contract that will be settled in a variable number of the entity's own equity. When a monetary authority has an obligation to replace currency in circulation at the holder's option, a contractual obligation exists to deliver cash. This meets the definition of a financial liability.

When a monetary authority concludes that no present obligation exists as a result of issuing currency, PSAB staff support recognizing revenue in the statement of financial performance.

Paragraph 99 of IPSAS 1, *Presentation of Financial Statements*, indicates all items of revenue and expense recognized in a period should be included in surplus or deficit, unless an IPSAS requires otherwise. PSAB staff interpret this paragraph as meaning that other IPSASs that exclude revenue and expense items from surplus and deficit do so to better reflect the economic substance of the arrangement. Such exclusion may occur when revenue is not attributable to the period in which it is earned or relates to activities outside of the entity's normal course of operations.

PSAB staff are of the view that revenue earned as a result of issuing currency is attributable to the period in which the currency is released into the money supply. When no present obligation exists, issuing currency results in an increase in resources available to the monetary authority. This increase in resources is based on a decision made in the current period and is not tied to future events (as is the case with various hedging relationships accounted for using hedge accounting).

Furthermore, as stated in paragraph 2.4, monetary authorities have a broad mandate to oversee various aspects of the economy, such as the issuance and maintenance of currency, management of reserve assets, and operation and administration of exchange rate stabilization funds. One of the key operations of the monetary authority is to issue and maintain currency. PSAB staff are of the view revenues and expenses generated from ongoing operations – or core operations of the entity – should be presented in the statement of financial performance.

Users of public sector general purpose financial statements use the information for accountability and decision making purposes. When decisions are made impacting the economic resources available to the entity in the current period, users should be able to easily identify the transaction in order to evaluate it. The fact that issuing currency is a primary role of a monetary authority indicates that the transaction should be prominently presented for the user in the statement in which they expect it to be presented. Recognizing revenue from issuing currency in the statement of net assets diminishes its importance and is not consistent with its nature as a primary duty of the entity; users expect revenue and expense transactions that are part of normal operations of an entity to be recorded in the statement of financial performance.

Preliminary View – Chapter 4 (following paragraph 4.14)

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 – Chapter 4?

Yes, PSAB staff agree with IPSASB's Preliminary View – Chapter 4.

Specific Matters for Comment – Chapter 4-1 (following paragraph 4.50)

(a) 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.

PSAB staff are of the view that entities should have the option to designate their intention for holding monetary gold assets. PSAB staff are of the view that this designation should impact the presentation of re-measurement gains and losses, not the measurement basis.

This view is driven primarily by:

- the market value of monetary gold is relevant to financial statement users regardless of the entity's intent in holding the item; and
- the physical attributes of one unit of monetary gold are identical to another – monetary gold is a fungible asset.

PSAB staff disagree with the argument that historical cost provides relevant information to a financial statement user in this instance. Providing a financial statement user with the acquisition costs of the monetary gold does not facilitate or enable accountability or financial decisions. In order to evaluate the performance of the monetary authority, the financial statement user needs to know the market value of the economic resources available to the entity (See response to Specific Matter for Comment – Chapter 4-2 for details). The nature of the activities of a monetary authority demand the use of a measurement basis that reflects the economic substance of its "business".

However, PSAB staff agree that the economic substance of gold held for trading and gold held for an indeterminate period is different. PSAB staff believe the measurement basis should be consistent regardless of the intent of holding the monetary gold – as this provides useful information – but IPSASB should reconsider the presentation of the re-measurement gains and losses.

When monetary gold is held for trading, the entity is holding the instrument to generate cash flows in the near term. As such, revenue earned on monetary gold held for trading is attributable to the current period.

When monetary gold is held for indeterminate period of time, the entity is holding the instrument to provide stability and liquidity in the monetary system, provide confidence in the monetary authority's financial strength and ability to carry out its activities. In these circumstances the market value gains and losses generated on monetary gold relate to a future period when the monetary gold may have to be disposed of to fulfill the monetary authority's mandate. One view is these gains and losses are attributable to the period(s) in which the monetary authority must exercise this part of its mandate.

The equity instrument model developed in IFRS 9 provides a measurement alterative IPSASB may wish to consider. Under the IFRS 9 model, an entity designates whether the equity instrument is held for trading or held as a strategic investment. Regardless of the election, the equity instrument is measured at inception and on an ongoing basis at fair value. However, the presentation of the fair value gains and losses differs. When the instrument is held for trading, fair value gains and losses are presented in the statement of operations. When the instrument is held for strategic purposes, fair value gains and losses are presented in Other Comprehensive Income.

Conceptually the IFRS 9 equity model aligns with the two categories proposed for monetary gold: held for trading and held for indeterminate period of time.

PSAB staff believe IPSASB should consider an approach similar to the IFRS 9 equity model. The benefit of an IFRS 9 type model is that fungible instruments are measured consistently on the statement of financial position, while the differences in economic substance are reflected in the presentation of the changes in market value. The IFRS 9 model would address concerns raised by monetary authorities that market value gains and losses associated with monetary gold held for an indeterminate amount of time will generate volatility in the statement of financial performance. Eliminating volatility from the statement of financial performance should satisfy monetary authorities – so they don't have to pay dividends – but also support financial statement users in their decision making.

Specific Matters for Comment – Chapter 4-2 (following paragraph 4.50)

(a) 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).

PSAB staff disagree with the argument that historical cost is an appropriate measurement basis for monetary gold in periods subsequent to initial recognition. PSAB staff are unable to identify scenarios in which an individual responsible for making financial decisions about whether to hold or sell monetary gold would apply historical cost in their decision making process.

Paragraph 4.25 indicates *the nature of monetary gold and its use by monetary authorities for reserve purposes means that information on the contribution to financial capacity is relevant. Monetary gold is not used directly in operations or to directly provide services, like other tangible assets. However, the acquisition cost and information on cost of services, provides relevant information for users, when monetary gold assets are intended to be held for an indeterminate period of time*.

While many monetary authorities have indicated they hold monetary gold to provide confidence in the monetary authority's financial strength and ability to carry out its activities, the historical cost of the monetary gold is not what is providing this confidence. It is the current market value of the gold that is the basis for the stability and confidence.

PSAB staff is of the view that monetary gold should be measured at inception and in subsequent periods at market value. Having the market value of monetary gold available facilitates the decision making process of financial statement users.

Preliminary View – Chapter 5-1 (following paragraph 5.12)

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?

Yes, PSAB staff agree with IPSASB's Preliminary View – Chapter 5-1.

Preliminary View – Chapter 5-2 (following paragraph 5.33)

The IPSASBs 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?

(a) PSAB staff agree IMF Quota Subscription meet the definition of an asset. Furthermore, PSAB staff believe the IMF Quota Subscription meets the definition of a financial asset in IPSAS 28.9.[2]

IPSAS 29.48 and 29.49 indicate there are two measurement models – amortized cost and fair value. Measurement of public sector specific financial instruments should be consistent with existing financial instrument guidance. PSAB staff are of the view accounting for the instruments at fair value at initial recognition and in subsequent periods yields consistent values as is proposed in IPSASB's dual measurement model. Measuring IMF Quota Subscriptions at fair value is also internally consistent with established financial instrument guidance.[3]

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[2] IPSAS 28 states a financial asset is any asset that is: cash; an equity instrument of another entity; a contractual right to receive cash or another financial asset or exchange financial assets/liabilities at potentially favorable terms; or a contract that may be settled in the entity's own equity. Table 5-2: Measurement indicates IMF members can redeem their quota subscription with the IMF and such a redemption is considered a sale in an active market. Since the Quota Subscription can be redeemed for cash, the instrument is a contract to receive cash and meets the definition of a financial asset in IPSAS 28.

[3] In preparing our response to PV – Chapter 5-2(a), PSAB staff initially used the term "market value" throughout. However, in order to achieve consistency with IPSAS 29, market value was replaced with fair value. PSAB staff are of the view the terms market value and fair value are interchangeable as it relates to IMF Quota Subscriptions. However, in

PSAB staff do not agree that there are benefits to developing a dual measurement model. Such a model may create complexity by requiring one measurement at initial measurement and another during subsequent measurement.

This response is written in the context of IPSAS 29. IPSASB should also consider this response in the context of its IFRS 9 convergence project. Assuming the measurement basis remains consistent with IFRS 9, financial instruments would continue to be measured at fair value or amortized cost. No option exists for financial instruments to be measured at net selling price.

(b) Yes, PSAB staff agree with IPSASB's Preliminary View – Chapter 5-2(b).

(c) Yes, PSAB staffagree with IPSASB's Preliminary View – Chapter 5-2(c).

PSAB staff note the accounting principles developed by IPSASB are largely consistent with existing guidance when accounting for general financial instruments in IPSAS 29. IPSASB should evaluate the need for guidance that is consistent with that for specific instruments already addressed in the general financial instrument section.

Other comments

Paragraph 3.33(a)

Paragraph 3.33(a) presents measurement alternatives for a legal obligation created as a result of issuing currency. Paragraph 3.33(a) indicates *regardless of whether historical cost or market value are more appropriate, the actual amount of the liability is equal. Measurement at either historical cost or market value gives rise to a liability equal to the cumulative face value of currency issued by the monetary authority.*

PSAB staff disagree with this assertion. While historical cost will equal the cumulative face value of the currency issued, market value may not.

Paragraph 7.24 of the Conceptual Framework defines market value as the amount for which a liability could be settled between knowledgeable, willing parties in an arm's length transaction. PSAB staff are of the view the market value of the liability to maintain or replace currency decreases the longer the currency is outstanding. For example:

- a monetary authority issues currency and obligation exists to replace it;
- as time passes this obligation is satisfied either through the exchange of currency, or currency being destroyed while in circulation;

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reviewing the definitions, market value and fair value are not synonymous. IPSASB should apply the term market value in its financial instruments update project to maintain consistency with its conceptual framework.

- when currency is destroyed during its use, the liability is reduced even though no exchange of funds has occurred.

Said another way, if the monetary authority were to transfer the obligation to replace the currency to another entity, the monetary authority would not have to transfer consideration equal to the face value of the cumulative amount of currency outstanding. This is because only a portion the currency issued will require replacement.

For this reason, PSAB staff are of the view historical cost and market value will not be equal throughout the life of the currency.

IPSASB should also consider the implication of measuring a currency in circulation liability at market value. Reducing a liability as it becomes less likely the outstanding currency will be replaced probably requires revenue to be recognized. While PSAB staff do not believe this is inherently incorrect, accounting for transactions of this nature was contentious in the private sector.

Existing guidance in IPSAS 29 and IAS 39 require fair value gains on instruments held for trading to be recorded in the statement of financial performance. As a result, a deterioration in an entity's credit quality can result in the recognition of revenue. This presentation perplexed financial statement users.

To address this concern, the IASB developed guidance in IFRS 9 requiring changes in fair value as a result of changes in own credit risk to be presented in other comprehensive income. While an increase in own credit risk and the extinguishment of a liability resulting from the destruction of currency are different facts and circumstances, we suggest that the IPSASB consider this perspective.

Paragraph 3.33(b)

Paragraph 3.33(b) presents measurement alternatives for non-legally binding obligations created as a result of issuing currency. Paragraph 3.33(b) indicates these non-legally binding obligations *may be more appropriately measured using the cost of fulfillment. This is because the future settlement of currency in circulation is uncertain in both time and amount.*

PSAB staff disagree a distinguishing factor between legally and non-legally binding currency obligations is the uncertainty in both time and amount. PSAB staff believe uncertainty in both time and amount is common to both legally and non-legally binding currency obligations. IPSASB staff considered this in paragraph 3.33(b), however it is dismissed. IPSASB concludes the contractual nature of the obligation justifies differences in measurement between legal and non-legal obligations.

If an entity has created an expectation they will perform a service identical to a service required by legal agreement, the measurement of that obligation should be consistent.

Paragraph 4.15 and 4.18(c)

Paragraph 4.15 and 4.18(c) indicate some financial instruments that allow for physical settlement in gold for which the monetary authority has the intention of taking physical delivery satisfy the definition of monetary gold. PSAB staff agree with this statement.

Paragraph 4 of IPSAS 29 indicates contracts to buy or sell non-financial instruments that can be settled net in cash are in scope of the financial instruments standards. However, if the contracts are entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements the contracts fall outside of the scope of IPSAS 29.

This creates a contradiction between the scope of the existing financial instruments suite of standards – which exclude contracts to purchase monetary gold where the intention is to take physical delivery – and the proposed monetary gold chapter.

In addition, if IPSASB wishes to include these contracts within the scope of the Consultation Paper, the paper should be clear what financial instruments are in scope. Paragraph 4.15 can be interpreted to include written options within its scope. Accounting for a non-financial item acquired using a written option at historical cost – based on an election in the Consultation Paper – contradicts existing guidance in IPSAS 29.6 indicating written options to purchase a non-financial item are within scope of the financial instruments suite of standards. These derivatives would be measured at fair value in accordance with paragraph 48 of IPSAS 29.

Paragraph 4.7

PSAB staff agrees with a significant amount of the guidance IPSASB developed for monetary gold. However, as noted in paragraph 4.7 *monetary gold does not meet the IPSAS definition of a financial asset because of its physical nature.*

IPSASB should evaluate the inclusion of guidance on monetary gold within the broader scope of the financial instruments project. PSAB staff suggest monetary gold be separated from the public sector specific financial instruments project, or the project be renamed to accurately indicate instruments within scope of the project.