WORLD BANK GROUP

January 30, 2017

Mr Ross Smith
Principal, IPSASB
International Public Sector Accounting Standards Board
277 Wellington Street West
Toronto, ON M5V 3H2

Re: *Consultation Paper (CP) on Public Sector Specific Financial Instruments*

Dear Ross,

We compliment the IPSASB in preparing the Consultation Paper (CP) on Public Sector Specific Financial Instruments. We have no specific comments on the three individual instruments that are widely used by the central banks as discussed in the CP. However, because IPSAS standards are largely based on the principles under International Financial Reporting Standards (IFRSs) but adapted to public sector context when appropriate, we would like to draw your attention to the current challenges faced by central banks in implementing the guidance on recognition of foreign exchange (FX) gains and losses under IAS 21, *The Effect of Changes in Foreign Exchange Rates* (IAS 21), for monetary assets not measured at fair value through profit and loss (FVPL) under IAS 39 *Financial Instruments: Recognition and Measurement* / IFRS 9 *Financial Instruments* (IFRS 9).

Our recommendation is to revise IPSAS 4, *The Effects of Changes in Foreign Exchange Rates* (IPSAS 4), such that, in certain instances, FX gains and losses on monetary assets are recognized in other comprehensive income (OCI).

Current guidance in IAS 21 and IPSAS 4 regarding recognition of FX gains and losses

Under the current guidance in IAS 21 and IPSAS 4, FX gains and losses from monetary items are treated differently from FX gains and losses from non-monetary items. The essential feature of a monetary item (e.g., a debt instrument) is the right to receive or an obligation to deliver a fixed or determinable amount of units of currency. A non-monetary item (e.g., an equity instrument) does not have this right. As you know, FX gains and losses on monetary and non-monetary items are treated as follows:

- Monetary items: FX gains and losses on the amortized cost of monetary items are always recognized in profit and loss regardless of the basis of measurement of the asset - i.e. regardless of whether the asset is measured at FVPL, fair value through other comprehensive income (FVOCI) or at amortized cost under IAS 39/IFRS 9 and IPSAS 29 *Financial Instruments: Recognition and Measurement* (IPSAS 29). For a monetary asset classified as FVOCI, the total change in fair value is bifurcated, with the portion associated with foreign exchange gains and losses on the amortized cost basis separately recognized in the income statement. It should be noted that the remaining portion of the total change in fair value recognized in OCI also includes FX gains and losses

- **Non-monetary items:** FX gains and losses on non-monetary items are recognized in income if the asset is measured at FVPL and in other comprehensive income (OCI), if the non-monetary item is measured at FVOCI.

Central bank accounting challenges – FX gains and losses

The World Bank Treasury, through its Reserves Advisory and Management Program (RAMP), provides advisory services and training to help central banks efficiently manage foreign currency reserves and other investment portfolios. The World Bank Treasury has over 15 years of experience in consulting and capacity building with official sector asset managers and manages over $29 billion in assets for over 55 emerging countries' central banks and other official sector institutions. As part of our capacity building initiatives we have noticed that central banks are usually unable to fully comply with IFRS.

In our experience as capacity builders, one of the areas where central banks are often unable to fully comply with IFRS, and hence current IPSAS, is with regard to recognition of FX gains and losses under IAS 21 on their foreign currency denominated reserve (FX reserve) portfolio, primarily comprising monetary assets. This is for several different reasons, including a legal imperative to comply with distribution policies prescribed in the local country laws that may require distribution from reported income.

Moreover, central banks hold FX reserves primarily to meet a multitude of objectives that include supporting and maintaining confidence in the policies for monetary and exchange rate management, demonstrating capacity to intervene in support of the national or union currency, limiting external vulnerability, among others. The management of the FX reserve portfolio is primarily driven by the exchange rate management policy objectives that can generate profits (bad) when the currency depreciates and losses (good) when the currency appreciates. Unfortunately, the current reporting requirements under both IFRS and IPSAS leads to income statement volatility and distorts the information on central banks' ability to meet their policy objectives.

Impact of divergence

Divergent practices among central banks on the recognition of FX gains and losses leads to varying levels of compliance, undermining global usefulness, comparability, understandability, transparency and verifiability. The central banks' challenge to fully comply with IFRS, or current IPSAS, undermines their perceived role as a regulator of commercial banks, which are expected to adhere to the recognized accounting standards.

The current level of non-compliance with respect to recognition of FX gains and losses is problematic to users of financial statements. Users of financial statements for central banks extend to credit rating agencies, ministries of finance, internal revenue [in certain instances like South Africa] and the International Monetary Fund. The major concern is for financial statement users who seek to verify whether the reserves are being managed appropriately, that the financial results are faithfully reflected through the application of sound reporting principles, and that accounting policies have not been opportunistically selected or "cherry picked". Global frameworks like IFRS or IPSAS, which could be applied by most central banks, provides a level of credibility to financial statement users, certainly an important consideration for smaller central banks.

Possible approach to the recognition of FX gains and losses on monetary items

While there could be various alternative approaches to addressing the issue central banks face in regards to the recognition of FX gains and losses on monetary items, a possible approach could be to consider aligning the recognition of FX gains and losses for monetary and non-monetary items classified as Available-For-Sale / FVOCI and to recognize those in OCI. This treatment is particularly relevant where monetary items in foreign currency are held to meet the prime objective for which the organization exists, rather than to make profit. For example, central banks aim to ensure that an economy is able to meet its foreign exchange demands and therefore hold a FX reserve portfolio comprising monetary assets to meet this objective. In such a case, the posting of FX gains and losses on the monetary assets to the income statement does not reflect the fact that management has absolutely no discretion to choose whether or not to take on foreign exchange exposure like commercial entities do. Posting FX gains and losses to OCI would also alleviate the complexity associated with current accounting requirement to recognize FX gains and losses on the *amortized cost* of such assets in profit and loss, while requiring recognition of all other fair value changes in OCI. We also believe similar treatment for monetary assets carried at amortized cost should be considered. Such a treatment would allow a central bank's performance to be measured consistent with its strategy. This would mean that if a monetary item is classified as FVPL then its FX gains and losses would also be recognized in profit and loss, and if a monetary item is classified as FVOCI or amortized cost then its FX gains and losses would also be recognized in OCI.

In conclusion, the CP is a very good start in addressing central bank specific challenges. By providing a more complete framework addressing foreign exchange under IPSAS 4, it is possible that other central banks may consider following the Reserve Bank of New Zealand's decision to adopt IPSAS. World Bank is willing to partner with IPSASB, stakeholders and other interested parties to deliberate and come up with a principle based approach within the current internationally recognized accounting framework to address the challenges facing the central banks. The issues with respect to recognition of FX gains and losses cited in this letter are not a central banking industry specific problem, but extend to many other non-profit institutions, particularly those which need to distribute profits to the government.

We look forward to collaborating with you on these specialized accounting topical areas.

Yours sincerely,

Pam O'Connell

Pamela O'Connell
Director and World Bank Group Chief Accountant