



**INTERNATIONAL FEDERATION  
OF ACCOUNTANTS**

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**Agenda Item**

**11**

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**DATE:** October 8, 2008  
**MEMO TO:** Members of the IPSASB  
**FROM:** Matthew Bohun-Aponte and John Stanford  
**SUBJECT:** Financial Instruments

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**OBJECTIVE OF THIS SESSION**

To **review** the additional documentation relating to the Financial Instruments project and agree a strategy to move forward.

**AGENDA MATERIAL**

- 11.1 Issues Paper – “Reserve Asset Recognition and Measurement”
- 11.2 Issues Paper – “Non-contractual Assets and Liabilities with Characteristics of Financial Instruments and Other Public Sector Financial Instruments
- 11.3 Rules of the Road Analysis of IFRICs 2, 9 and 16
- 11.4 Cut and Paste of Member Responses to Further Issues Paper (copies of member responses are available on request)

**ACTION REQUIRED**

The IPSASB is asked to:

- **Discuss the issues and proposals** as outlined in the attached issues papers and questionnaire responses; and
- **Provide** staff with direction on issues to be addressed in the development of EDs for the February 2009 IPSASB meeting.

**BACKGROUND**

At its June meeting, the IPSASB considered various proposals regarding the development of IPSASs based on IFRS 7, “Financial Instruments: Disclosures”; IAS 32, “Financial Instruments: Presentation” and IAS 39, “Financial Instruments: Recognition and Measurement”. At that meeting members expressed reservations about making extensive changes to the IFRSs when developing the IPSASs. This concern was primarily driven by the complexity of the IFRSs and the desire to avoid unintended consequences by making changes to the IFRSs. Members also felt that amending the IFRSs would likely make already complex documents even more complex. Consequently members requested that staff:

1. Seek further examples of the central bank treatment of monetary gold, Special Drawing Rights, reserve position in the IMF and currency issued by public sector entities.
2. Not make significant amendments to definitions in the IFRSs, but that the application of the definitions in the public sector be clarified by way of commentary or guidance.
3. Not depart from the classification scheme in IAS 39. Members prefer that commentary, guidance and examples be provided to illustrate how different types of financial asset might be classified in particular circumstances. Members deferred discussion on reclassification.
4. Reconsider how the principle of substance over form is to be applied to financial instruments and report back at the next meeting.
5. Consider further whether the IAS 39 provisions for hedging of a net investment in a foreign operation should be included in draft EDs.
6. Proceed on the basis that there will be no departure from the disclosure requirements of IFRS 7.
7. Commence developing application guidance and examples for inclusion in the IPSAS financial instruments standards.
8. Develop a rules of the road analysis of IASB IFRIC 2, “Members’ Shares in Co-operative Entities and Similar Instruments”, IFRIC 9, “Reassessment of Embedded Derivatives” and IFRIC 16, “Hedges of a Net Investment in a Foreign Operation”.

Staff have not provided a mark up of IFRS 7, IAS 32 or IAS 39 at this stage. The intention is to obtain clear directions on the issues raised in this memorandum, so that a mark up of the IFRSs can be brought to the February 2009 meeting. Staff of the South African accounting Standards Board have agreed to provide assistance in producing the mark ups.

### **Reserve Assets**

The attached Issues Paper, “Reserve Asset Recognition and Measurement” (agenda item 11.1) provides further discussion of public sector specific items and reviews the financial reporting of monetary gold, Special Drawing Rights (SDRs), reserve position in the IMF and currency issued by the entity. Staff examined financial reporting by Australia, Canada, the European Community, France, New Zealand, Singapore, Switzerland, South Africa, the United Kingdom and the United States of America. These countries were selected because their financial statements were available in English on the internet and represented a range of different treatments.

The main observations of the discussion paper are:

- Not all central banks are public sector entities.
- Central banks are generally responsible for issuing bank notes, and recognize a liability for notes on issue at the face value of those notes, less an allowance for notes believed to be out of circulation.
- Monetary gold is held by most governments. It may be recognized as an asset of the central bank, the mint, or the government. Where the central bank is outside the public sector, it may have custody of the gold on behalf of the government. Gold may be measured at its market value or at historic cost or a proxy for historic cost.
- Coins are more frequently issued by a mint, which is usually classified as a public non-financial corporation. The difference in the face value of individual coins and the fair value of the metal in the coins is usually not material so neither mints, nor their controlling governments recognize a liability for coins.
- Whilst the difference in the face value and metal value of individual coins may not be material, the cost of minting coins in a given year is normally different to their face value; this difference is recognized as a revenue or expense by mints that they refer to as “seignorage.”
- SDRs may be held either by a government controlled central bank or by the government itself. SDRs are recognized in the financial statements and may be measured either at cost or at fair value.
- The reserve position in the IMF is normally recognized by the government, not the central bank, and may be measured at cost or fair value;
- All the governments investigated make sufficient disclosures about these items for staff to have been able to determine the amount recognized in respect of these items, and the respective government’s accounting policy. The disclosures made do not display any uniformity.

### ***Discussion and recommendation***

Staff are of the view that whilst the governments/central banks observed do develop accounting policies for the recognition, measurement, presentation and disclosure of these items, these policies are diverse and not rigorously consistent with IPSASs or IFRSs. In addition to the items discussed above, governments usually include foreign exchange as part of their reserve assets. This particular asset is not addressed in the discussion paper. However, while examining governments’ financial statements, staff observed that governments reporting of foreign currency holdings is consistent with IPSAS 4, “The Effects of Changes in Foreign Exchange Rates”.

Staff conclude that public sector financial reporting would be enhanced if an IPSAS is developed that establishes uniform recognition, measurement, presentation and disclosure requirements in respect of these items. Staff do not believe that such a project would be resource intensive and could be progressed as a separate sub-project of the financial instruments project. Staff do not believe that the definition of financial instruments should be modified to include these items.

**Decision: Does the IPSASB agree that an ED should be developed to establish uniform recognition, measurement, presentation and disclosure requirements for reserve assets?**

**Non-Contractual Assets and Liabilities with Characteristics of Financial Instruments and Other Public Sector Financial Assets**

The attached Issues Paper on “Non-Contractual Assets and Liabilities with Characteristics of Financial Instruments and Other Public Sector Financial Instruments” (agenda item 11.2) examines examples of non-contractual items in IPSASs that have characteristics of financial instruments. The Issues Paper also presents examples of other non-contractual items that members provided to staff, and how those items are reported in the financial statements of the relevant public sector entity. The Issues Paper canvasses several financial reporting treatments for these items including:

- Amortized cost using the effective interest rate method, less any accumulated impairments;
- Nominal value; and
- Fair value.

Staff are of the view that further examples should be examined, but that the IPSASB should initiate a project to develop requirements for the subsequent measurement of those items arising from non-exchange transactions that are already addressed in IPSASs (for example IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)”) with a view to including additional requirements within the relevant standard. For those items that have yet to be addressed in an IPSAS, including items with characteristics of financial instruments arising from social policy obligations, the initial and subsequent measurement of those items should be addressed as the IPSASB develops appropriate standards. Staff are of the view that these items should not be addressed in the convergence phase of the financial instruments project.

**Decision: Does the IPSASB agree that an ED should be developed to address the subsequent measurement of items with characteristics of financial instruments arising from IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)” and other IPSASs that may be identified in the course of this project, and not deal with these items as part of the convergence project?**

**IFRICs 2, 9 and 16**

At agenda item 11.3, staff have provided a rules of the road analysis of IFRIC 2, “Members’ Shares in Co-operating Entities and Similar Instruments”; IFRIC 9, “Reassessment of Embedded Derivatives” and IFRIC 16, “Hedges of a Net Investment in a Foreign Operation”. As noted in the analysis, staff have not identified any public sector issues in relation to IFRIC 2 or IFRIC 9 and recommend that these IFRICs be incorporated into the ED to be developed to address financial instruments. In relation to IFRIC 16 staff have reiterated the view of some that hedging does not promote transparency in financial reporting, and have highlighted reservations about incorporating hedging arrangements into IPSASs based on IFRS 7, IAS 32 and IAS 39. The IPSASB

has not decided definitively whether to allow or disallow hedge accounting. As is noted in the next section, members responding to the questionnaire circulated between meetings favor the retention of hedge accounting. The incorporation of IFRIC 16 in the ED of an IPSAS, primarily drawn from IAS 39, is obviously dependent on broader decisions on hedge accounting.

**Decision: Does the IPSASB agree that IFRICs 2 and 9 should be incorporated into any IPSASs developed from IFRS 7, IAS 32 and IAS 39?**

**Decision: Does the IPSASB agree that hedge accounting should be permitted and that IFRIC16 should be incorporated into the IPSASs addressing financial instruments?**

### **Further Issues Paper**

After the June meeting of the IPSASB, staff sent members a further issues paper asking whether members support the following proposals in relation to the development of the IPSASs to address financial instruments. Staff received nine responses from members and a TA and some observations from the EC observer. A summary of the general tenor of the responses is noted below. Item 11.4 provides a cut and paste of the comments, and copies of the responses are available from staff on request.

- 1. Do not modify the definitions of financial instrument, financial assets and financial liability to include non-contractual binding arrangements. (8 agree, 1 disagrees)*

In addressing the definitions members generally agreed that it would take considerable time to address definitions of non-contractual items with characteristics of financial instruments and that these would be better addressed in a separate project. One member was concerned that failing to address these items now would mean that we were not adding value for our constituents and that resources might be better deployed by withdrawing IPSAS 15 and allowing the hierarchy established in IPSAS 1 to direct preparers to the IFRSs.

Staff are of the view that incorporating non-contractual binding arrangements into the definitions would create significant issues that would not be resolved quickly. Whilst staff acknowledge that excluding these items does not address a significant public sector issue, staff would recommend that the definitions not be changed, but that a separate project component should address these items and that a new IPSAS, or a revision to IPSAS 23, be developed.

- 2. Retain the notion of settlement in own equity instruments in the definition of a financial liability. (7 agree, 2 disagree)*

Members noted that such transactions are likely to be extremely rare in the public sector, but that it is better to leave the definition as it is to avoid any issues that might arise on consolidation. One dissenting member thought that we ought not to

include the reference to settlement in an entity's own equity instruments because such transactions are rare and the possibility of consolidation issues did not warrant including provisions about settlement in an entity's own equity instruments. The other dissenting member disagreed with this approach as it does not address public sector issues. One member, whilst agreeing that the definition ought to be changed, recommended against including a specific matter for comment, because that would raise the profile of this issue beyond its relative importance.

Staff note the concerns of members that transactions in own equity instruments will be rare in the public sector and will likely be restricted to those public sector entities that control partially privatized government business enterprises. Nevertheless, staff are aware that the phased privatization of government business enterprises is an increasingly common phenomenon and should be accommodated in the IPSASs. Staff are aware of a number of public sector entities around the world that control partially privatized GBEs and would not discount the possibility that financial liabilities would be satisfied with the transfer of equity instruments in these partially privatized GBEs. Staff, therefore recommend that the definition of financial liability continue to refer to settlement in an entity's own equity instruments.

3. *Permit entities to reclassify a financial instrument into or out of the category "fair value through the surplus or deficit:" when fair value becomes reasonably determinable or ceases to be reasonably determinable, but not further classification is permitted. (5 agree, 4 disagree)*

The members that disagree with this proposal are not convinced that there is a public sector reason to make a change from the IFRS position. Members who support the proposal believe that it is a practical development that will assist preparers, with one member noting that the IFRS approach to the subject of reclassification is overly rules based.

Staff are of the view that there is a case to be made for allowing the proposed approach to reclassification. Due to the lack of consensus within the IPSASB about this proposal, staff are of the view that there should be a specific matter for comment that addresses this issue specifically. Staff would welcome further discussion of this issue at the meeting in October. Staff are aware that there is an agenda item on the elimination of inconsistencies in how IAS 39 and US GAAP practice address the issue of reclassifications and whether to eliminate any differences. Staff will monitor whether modifications to the current requirements on reclassification are likely to arise and the timelines for any proposed changes.

4. *Liaise with the staff of the European Commission on the approach to determining the fair value of a financial guarantee provided at zero consideration. (9 agree/note the liaison effort)*

Members support the principle that staff should liaise with prominent preparers who have had recent and relevant experience in attempting to determine a fair value for guarantees provided at zero consideration.

5. *In relation to hedging, the ED should be drawn primarily from IAS 39 and should reflect the current requirements of IAS 39. (8 agree, 1 prefers to wait and see)*

Members support basing IPSASB hedging requirements on those of IAS 39, However, members did note that these provisions are complex and there may be further developments in this area from the IASB, dependent on responses to, and further deliberations on the Discussion Paper on “Reducing Complexity in Reporting Financial Instruments.”

Staff, while supporting the proposal to converge with IAS 39, reiterate the reservations expressed in the June agenda papers concerning permitting entities to offset financial assets and liabilities to reflect a hedged position. Staff would prefer that entities recognize assets and liabilities separately, and make disclosures about their risk management policies in the notes to the general purpose financial statements.

## **Summary**

In general, responding members prefer not to modify the provisions of the IFRSs in developing the IPSASs, although no consensus exists on a more permissive approach to reclassification. Staff are of the view that an ED should be prepared that proposes as few changes as possible to the IFRSs, and that such additional explanations as are required be included in application guidance. Staff would prefer not to delete any material from the standard or the mandatory application guidance. In relation to the non-mandatory Illustrative Guidance and Illustrative Examples, these should be made more relevant to the public sector.

**Decision:** Does the IPSASB agree that staff should proceed to adapt IFRS 7, IAS 32 and IAS 39 to the public sector by preparing an exposure draft that retains the IFRS definition of financial instrument, financial asset and financial liability; retains the notion of settlement in own equity instruments, and retains the IAS 39 hedge accounting requirements?

**Decision:** Does the IPSASB agree that staff should modify the IFRS reclassification provisions to permit entities to reclassify a financial instrument into or out of the category “fair value through the surplus or deficit:” when fair value becomes reasonably determinable or ceases to be reasonably determinable, but not otherwise?

## **NEXT STEPS**

Staff will prepare a draft ED that proposes issuing IPSASs based on IFRS 7, IAS 32 and IAS 39, and that also proposes withdrawing IPSAS 15, “Financial Instruments: Presentation and Disclosure”, for the February 2009 meeting. Staff will be assisted by Jeannine Poggiolini of the Accounting Standards Board (South Africa) in developing the exposure draft.

**Matthew Bohun-Aponte**  
**TECHNICAL MANAGER**  
**John Stanford**  
**DEPUTY DIRECTOR**

## **RESERVE ASSET RECOGNITION & MEASUREMENT**

### **Role of Central Banks**

Most countries have a central bank. The role of central banks has evolved over the course of several centuries, perhaps most rapidly since the middle of the twentieth century. Most, but not all, central banks are public financial corporations that are wholly owned by the national government.<sup>1</sup> At present, the key roles of central banks include:

- Development and/or implementation of monetary policy;
- Prudential supervision of the banking industry;
- Provision of transactional banking services to the national government;
- Issuing of currency (notes and in some circumstances, coins); and
- Ownership or custody of a national government's reserve assets.

Not all central banks perform all these functions, and some central banks have functions in addition to these. This paper does not focus on the first three dot points above, although most central banks would argue that these are the most important functions.

This paper explores the key issues around recognition and measurement of assets of central banks, and, in an appendix, provides examples of the approach taken by some individual central banks.

### **Issuing Currency**

#### **Bank Notes**

Issuing bank notes is normally the responsibility of the central bank, although in some jurisdictions this responsibility is also shared by, or delegated to, retail banks. Central banks recognize a liability for the face value of the currency on issue. In some cases the liability will be reduced by the face value of bank notes that the central bank estimates will never be redeemed, because they have passed into a collection (and their value as collectibles is higher than their face value) or because some notes are destroyed or lost. In some cases banks issuing circulating bank notes are required to have collateral for all notes on issue, for example, the US Federal Reserve is required to hold US Treasury securities for bank notes it issues. Printing of bank notes may be undertaken by the central bank itself, by a controlled entity, a separate but related entity, or contracted to a third party (such as another central bank).

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<sup>1</sup> The "Government Finance Statistics Manual 2001" specifies that the central bank is part of the financial corporations sector, which consists of all corporations, quasi-corporations, and market non-profit institutions principally engaged in financial intermediation or in auxiliary financial activities closely related to financial intermediation. The GFSM 2001 further notes that in some cases, this sector is disaggregated into three subsectors: the central bank, other depository corporations, and financial corporations not elsewhere classified. The material reviewed by staff would indicate that the central bank is always part of the GFSM financial corporations sector and, where it is government owned, it will be a public financial corporation. The material reviewed by staff does not conclusively lead staff to the view that all government owned central banks satisfy the definition of Government Business Enterprise in that staff are unsure whether all central banks contract in their own name, or whether some central banks contract in the name of the government that controls them.

In the past, bank notes were viewed as promissory notes, and often contained words to the effect that the note could be redeemed for the face value of the note. Historically, this meant that the note could be exchanged at the issuing bank for coins minted from precious metal (gold or silver) for the face value of the note. Whilst some bank notes may still bear these words, the modern promise is to exchange the note for another note or notes of the same value. In most jurisdictions notes are printed with words to the effect that they are legal tender.

### **Coins**

A few central banks have responsibility for issuing coins. The minting of coins is, however, more commonly the responsibility of a separate entity called a mint, normally owned by the government, but distinct from the central bank. Some countries do not have their own mints, but contract coin production to the mint of another country. Historically, the face value of coins reflected the market value of the precious metal they were minted from; consequently, mints (and their controlling governments) do not recognize a liability for the coins they issue. In practice, there may be a slight variation in the cost of minting a coin and the coin's face value, this difference is recognized as a gain or a loss by the issuing mint or bank, and is referred to as seignorage. Where the value of metal increases such that a coin's metal value is significantly higher than its face value, it is common practice for mints to withdraw those coins and redesign coins such that the difference declines, or to discontinue issuing low denomination coins.

Coins are often placed in circulation by the central bank, which then distributes them to the retail banking sector. The central bank will purchase coins from the mint at their face value and distribute them to retail banks when those banks make withdrawals from their accounts at the central bank. The central bank may pay for new coins with older worn coins, which the mint will then melt down for scrap or to make new coins.

Mints recognize that coins have value as collectibles, and most mints cater to this market and earn significant revenue by supplying "proof", "uncirculated" and special issue coins.

Coins are viewed as an asset, a store of value, in their own right, consequently mints view their distribution as analogous to the sale of a commodity, and therefore, once the transaction is complete, the mint has no further ownership or financial interest in the coins.

### **Reserve Position in the IMF and SDRs**

Special Drawing Rights (SDRs) "are international reserve assets created by the IMF and allocated to its members to supplement existing reserve assets. SDRs are held only by the monetary authorities of IMF member countries and a limited number of authorized international financial institutions. An SDR is a financial asset for which there is no corresponding liability, and the members to whom they have been allocated do not have an unconditional liability to repay their SDR allocations. A general government unit will hold SDRs only when it acts as the monetary authority." (GFS Manual 2001, paragraph 7.95). In practice it would appear that national governments do not give control of SDR allocations to the central bank, but retain control through the ministry of finance or treasury. The central bank may, however, act as custodian on behalf of the government,

although it would seem that decisions relating to the sale or purchase of SDRs would be made by the government as beneficial owner and not the central bank as custodian. SDRs are most often measured at the quoted price on reporting date, which is determined by the IMF. <sup>2</sup>Some countries measure SDRs at the quoted price on the date of acquisition (analogous to historical cost).

SDR's are defined in terms of a basket of currencies, the market value of which determines the market value of the SDR.

A country's reserve position in the IMF is the amount of its quota less IMF holdings of that country's currency. A country's quota is determined by the IMF Executive Board, which will also determine any increases. A country's voting rights, allocation of SDRs, and the amount of its subscription and loan facilities will be determined by its quota. A country's reserve position is most often treated as a form of equity in the IMF and is held by the country's national government, although the central bank may act as custodian. A country's reserve position can be expressed in units of SDRs and is, therefore, often measured at the quoted price on reporting date, or the quoted price on the date of acquisition.

### **Examples of Central Bank Financial Reporting**

#### **Australia Reserve Bank of Australia (RBA)**

The Reserve Bank of Australia is the central bank of Australia. It is a public financial corporation wholly owned by the Commonwealth of Australia (Federal Government).

The RBA is responsible for issuing Australian banknotes, which are printed by its subsidiary Note Printing Australia. RBA recognizes notes on issue as a liability at their face value, less an assessment of notes believed to be destroyed or not otherwise likely to be redeemed. Coins are issued by the Royal Australian Mint, a controlled entity of the Commonwealth of Australia within the Treasurer's portfolio of responsibility. The RBA orders coins from the Royal Australian Mint and distributes them to commercial banks. A liability for coins on issue is not shown as a separate line item in the financial statements of the RBA, Royal Australian Mint nor Commonwealth of Australia. Seignorage is recognized by the Royal Australian Mint as a revenue line item administered on behalf of the Commonwealth of Australia.

The RBA recognizes gold at its fair value. Gold loans are classified as financial instruments.

All other financial instruments held by the RBA are held at fair value.

SDRs and Australia's Reserve Position in the IMF are recognized as financial assets of the Commonwealth of Australia in its Consolidated Financial Statements. SDRs are

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<sup>2</sup> If the central bank is not a public financial corporation, as is the case in South Africa and USA, the central bank has no ownership interest in SDRs or the reserve position in the IMF, but may hold them as custodian, or as an agent of the national government.

measured at the quoted price. Australia's equity in financial institutions including the IMF is measured at historical cost.

**Canada  
Bank of Canada (BoC)/Banque du Canada**

The Bank of Canada is the central bank of Canada. It is a public financial corporation wholly owned by the federal government of Canada.

The BoC is responsible for printing and issuing Canadian banknotes, BoC recognizes a liability for bank notes on issue, which are measured at their face value. Coins are minted by the Royal Canadian Mint/La Monnaie Royale Canadienne. A liability for coins on issue is not shown as a separate line item in the financial statements of the BoC, the Royal Canadian Mint nor the Public Accounts of the Government of Canada.

BoC recognizes gold at its estimated historic cost of SDR35 per fine ounce, translated into Canadian Dollars.

Financial instruments recognized by the BoC are classified as held for trading (HFT), available for sale (AFS), held to maturity (HTM) or loans and receivable (L&R). The BoC has not classified any assets as HFT. AFS are measured at fair value. HTM and L&R are measured at cost less amortization using the effective interest rate method. Shares in the Bank of International Settlement are recognized at cost as there is no market for these shares.

SDR's held by the Canadian government in its Exchange Fund Account are measured at the quoted price at year end. Canada's reserve position in the IMF is measured at historical cost.

**European Community  
European Central Bank**

The European Central Bank is the central bank of the European Community, member states also have their own central banks. The ECB is a public financial corporation that is owned by the central banks of the Eurozone and other EC central banks. The main functions of the ECB are to set interest rates in the Eurozone, maintain price stability, to define and implement monetary policy, conduct foreign currency transactions, promote the smooth operating of the banking payment system and authorize the issuance of euro banknotes and coins.

The ECB does not issue bank notes or coins, but authorizes Eurozone central banks to issue them. The ECB recognizes a liability for bank notes on issue at their face value, this represents the ECB's allocation of banknotes on issue in the Eurozone, which is approximately 8% of all Euronotes on issue. The ECB does not recognize any amounts in respect of coins.

The ECB measures its gold holdings at market value as at the reporting date.

The ECB holds SDRs and measures them at the market value. For financial reporting purposes SDRs are treated as foreign currency.

**France  
Banque de France**

Banque de France (BdF) is the central bank of France. It is a public financial corporation owned by the government of France.

BdF is responsible for circulating Euro banknotes and coins through its network of branches throughout France. It also prints Euro banknotes. France is allocated an amount of Euro notes by the European Central Bank (ECB). BdF recognizes this as a liability at face value.

La Monnaie de Paris is a French government owned corporation that has sole responsibility for minting French coins, which are circulated through the BdF. No liability is recognized in respect of coins in circulation.

BdF recognizes France's gold reserves and measures gold at its fair value.

BdF recognizes France's SDR's and reserve position in the IMF, these are measured at the IMF quoted price converted to Euro.

**New Zealand  
Reserve Bank of New Zealand (RBNZ)**

The Reserve Bank of New Zealand is the central bank of New Zealand. It is a state owned enterprise of the New Zealand Government.

The bank holds NZ's foreign currency reserves, and "Other Reserve Assets" (including gold). These are measured at market values.

NZ Treasury holds NZ's reserve position in the IMF and its Special Drawing Rights in the IMF. SDRs are measured at the market value, the reserve position at the IMF agreed value.

RBNZ is responsible for administering the printing of NZ banknotes and minting of NZ coins, and for issuing and withdrawing them. Currency on issue is reported as a liability of the RBNZ at their face value.

**Singapore  
Monetary Authority of Singapore**

The Monetary Authority of Singapore (MAS) is the central bank of Singapore, it is a public financial corporation owned and controlled by the government of Singapore.

The MAS holds foreign exchange reserves, gold, Special Drawing Rights and Reserve Position in the IMF.

Gold is measured at historic cost. The notes to the financial statements state that if the market price is lower than cost, the diminution in value would be recognized in the financial statements.

MAS is responsible for issuing currency and recognizes a liability for currency in circulation at face value. MAS maintains a “Currency Fund” established by act of Parliament, which holds assets to collateralize the currency on issue. The assets of the currency fund are gold (at historic cost) and foreign assets (at market value). The assets of the currency fund exceed the liability for currency in circulation by a significant margin. Coins are issued by the Singapore Mint, which does not publish separate financial statements.

MAS also recognizes Singapore’s Reserve Position in the IMF and Singapore’s holdings of SDR’s in its financial statements. The reserve position is measured at cost. SDR’s are measured at fair value.

### **South Africa**

#### **Central Bank: South African Reserve Bank (SARB)**

The South African Reserve Bank is the central bank of South Africa. It is a company limited by shares, which are traded in an over the counter market. It has 2,000,000 authorized shares, the maximum number of shares that can be held by a single shareholder is 10,000. There are currently more than 600 shareholders. Whilst the bank is a private sector entity, it pays its surplus after tax, dividends, and certain provisions, to the government of South Africa.

The bank is the custodian of South Africa’s foreign currency reserves and gold reserves.

The bank is the sole issuer of currency in South Africa. It prints notes and mints coins through wholly owned subsidiaries.

Gold is measured in the financial statements at its current market value.

SDRs are measured at market value.

Reserve position in the IMF is measured at IMF agreed amount.

Net currency on issue is recognized as a liability of the SARB at face value.

### **Switzerland**

#### **Swiss National Bank**

The Swiss National Bank (SNB) is the central bank of Switzerland. The SNB is a publicly traded company, with approximately 55% of its shares owned by public institutions and cantonal banks, with the balance being widely held.

SNB has the sole authority to issue Swiss Franc banknotes, it recognizes a liability for banknotes in circulation at their face value. Swissmint is a controlled entity of the Swiss federal government and is responsible for minting Swiss coins.

The SNB recognizes Switzerland's gold reserve at market value.

SNB recognizes all negotiable financial instruments at fair value.

### **United Kingdom Bank of England**

The Bank of England (BoE) is the central bank of the United Kingdom. The BoE is a wholly owned controlled entity of the UK Government.

BoE has the monopoly on the issue of banknotes in England and Wales. In Scotland and Northern Ireland, seven commercial banks have the right to issue circulating promissory notes (de facto banknotes). Jersey, Guernsey and the Isle of Man also issue Sterling banknotes. Some other British colonies also issue notes pegged to the pound sterling. The BoE and each of the other issuing banks or authorities recognize a liability for circulating banknotes at their face value. BoE banknotes have the words "I promise to pay the bearer £N", the BoE's Frequently Asked Questions section on its website explains that this does not mean that notes can be exchanged for gold or any other store of value, but only for other BoE banknotes.

The Royal Mint produces and issues coins for the UK. Jersey, Guernsey and The Isle of Man also issue sterling coins. A liability for coins on issue is not shown as a separate line item in the financial statements of the Royal Mint.

The United Kingdom's gold reserves, foreign exchange reserves, SDR's and reserve position in the IMF are held in the Exchange Equalization Reserve account, which is managed by the BoE as agent for the UK government. The balances and transactions in these assets are not recognized by the BoE, but are recognized in the financial statements of the UK Government. Gold is recognized at its fair value with changes in fair value recognized in profit and loss. SDRs are recognized at the IMF quoted exchange rate.

### **United States of America Federal Reserve System**

The Federal Reserve System is the central bank of the United States of America. It is a federal government agency established by act of Congress. It comprises twelve regional Federal Reserve Banks under a board of governors. The twelve regional banks are private financial corporations owned by commercial banks in their region.

The US Treasury is responsible for the manufacture and distribution of Federal Reserve Notes (US banknotes) and coins. Banknotes are printed by the US Bureau of Engraving and Printing. US Coins are produced at the US Mint. The US Bureau of Engraving and Printing and the US Mint are controlled entities of the US Treasury. Notes and coins are distributed through the Federal Reserve Banks and their twenty-five branches throughout the USA, these banks then distribute them to retail banks. The Federal Reserve System recognizes a liability for net outstanding Federal Reserve Notes which is measured at their face value. The Federal Reserve System is required to collateralize Federal Reserve Notes, normally with securities issued by the US Treasury. No liability is recognized in respect of circulating coins; however, the US Mint recognizes seignorage revenue or loss

for the difference between the face value of coins and the cost to mint coins in a given year.

The US Mint has custody of most of the USA's reserves of gold and silver. These are recognized at the statutory price of USD42.22 per fine troy ounce for gold, and USD1.29 per fine troy ounce for silver.

The US Treasury holds SDRs and the reserve position in the IMF in its Exchange Stabilization Fund. It also issues SDR Certificates to the US Federal Reserve System in exchange for Federal Reserve Notes. These are recognized and measured at the IMF quoted price.

### **Conclusion**

The analysis presented in the paper shows that, while the central banks, mints and treasuries studied all present accrual based financial statements, these statements are prepared in accordance with national financial reporting standards or the relevant legislation, rather than in accordance with IPSASs or IFRSs. Consequently, each jurisdiction has developed different accounting policies, in particular different policies for the subsequent measurement of assets. Some of these policies would be broadly consistent with IPSASs and IFRSs in that they measure assets at either historical cost or fair value, but other policies, particularly those that measure assets at a statutory price, or in a currency other than the functional or reporting currency, would not be consistent with IPSASs or IFRSs.

Staff are of the view that, a divergence of accounting policies is apparent, and that this is not desirable because it does not further the qualitative characteristics of public sector financial reporting in that these divergent policies do not make the resultant financial statements comparable with each other. Staff are of the view that the IPSASB should initiate a separate sub-project of the financial instruments project to develop an IPSAS that addresses these issues. Staff are of the view that the IASB will likely never address these issues, therefore, it is the responsibility of the IPSASB to address these issues, even if many of these reporting entities may ultimately decide to adopt IFRS rather than IPSASs.

## **Non-contractual Assets and Liabilities with Characteristics of Financial Instruments and Other Public Sector Financial Instruments**

### **Introduction**

The IPSAB has considered the implications of amending IFRS 7, “Financial Instruments: Disclosures”, IAS 32, “Financial Instruments: Presentation” and IAS 39, “Financial Instruments: Recognition and Measurement” to non-contractual items with characteristics of financial instruments. The IPSASB members have indicated that IPSASB equivalents to IAS 32, IAS 39 and IFRS 7 should not be modified to include these non-contractual items. Members have noted that the IFRSs are very complex and if the IPSASB modifies the scope or definitions to include non-contractual items, it may not achieve the goal of developing comprehensive requirements for non-contractual items, and will, inevitably, make already complex standards more complex. Members have expressed a preference for developing separate requirements for non-contractual items.

The non-contractual items considered are various loans, receivables or payables that arise from the operation of statutes or other non-contractual agreements, such as international treaties. This paper examines several examples of these types of assets and liabilities. The aim is to explore possible financial reporting options for these items with a view to developing a consultation paper or exposure draft that proposes new IPSAS requirements for the recognition, measurement, presentation and disclosure of these items.

### **Recognition and Measurement**

Some non-contractual items are recognized and initially measured in accordance with extant IPSASs, most notably IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)”. IPSAS 23 requires the recognition of items arising from taxation, fines, grants and a range of other non-contractual events at their fair value. IPSAS 23 anticipates that many of these items will result in a flow of cash to the reporting entity within the current reporting period, or within a foreseeable number of reporting periods. IPSAS 23 does not address payables. The principles established in IPSAS 23 require that items be initially recognized at their fair value, being the best estimate of the present value of the future cash flows to the entity. IPSAS 23 does not address subsequent measurement of these items.

### **Presentation and Disclosure**

IPSASs currently prescribe presentation and disclosure requirements for a range of assets, liabilities, revenues, expenses, cash flows and other information that assists users of public sector financial statements. The presentation and disclosure requirements of IFRS 7, IAS 32 and IAS 39 are necessarily complex due to the complex nature of modern financial instruments. It is arguable that, in respect of non-contractual items, simplified presentation and disclosure requirements may be possible. At a minimum, it is anticipated that an IPSAS would identify whether items are to be presented on the face of the financial statements or in the notes, and require disclosure of information about the risks and expected cash flows associated with particular non-contractual items. Further

presentation and disclosure requirements are expected to be identified as the project progresses.

## **Examples of Non-Contractual Items**

### **Receivables and Payables – Non-exchange Transactions**

IPSAS 23 establishes requirements for the recognition and measurement of revenue arising from non-exchange transactions. It does not directly address payables, such as grants or concessional loans payable, or the subsequent measurement of receivables, such as taxes or grants receivable. The principle established in IPSAS 23 is that items arising from non-exchange transactions should be measured at fair value at initial recognition when determining the amount of revenue to be recognized. This principle has been extended to the acquisition of inventory, investment property and property, plant and equipment. IPSAS 12, “Inventories”, IPSAS 16, “Investment Property” and IPSAS 17, “Property, Plant and Equipment” all require assets to be measured initially at cost, however, where assets are acquired through a non-exchange transaction, cost is the fair value as at the date of acquisition.

In respect of subsequent measurement the IPSASs adopt one of three principles. Inventories are measured at the lower of cost, or net realizable value except where they are held for distribution at no charge or for a nominal charge, or held for consumption in the production process of goods to be distributed at no charge or for a nominal charge, in which case they are measured at the lower of cost or current replacement cost. Investment property or property, plant and equipment is either measured at its fair value, or at cost less accumulated depreciation or amortization.

In determining the appropriate requirements in respect of non-contractual items, the IPSASB will be cognizant of these principles already established. However, some non-contractual items have many of the same characteristics as financial instruments such as accounts receivable and payable. Under IAS 39, financial assets that are classified as loans and receivables, and most financial liabilities, are initially measured at cost, and subsequently at amortized cost using the effective interest rate method (see IAS 39, paragraph 46(b) and paragraph 47).

Using the effective interest rate method for subsequent measurement of receivables and payables arising from non-exchange transactions may be difficult in practice as there are many uncertainties surrounding the timing and amount of future cash flows. Some of these practical difficulties were discussed in IPSAS 23, and in previous meetings.

### **Concessional Loans**

Many governments provide citizens, permanent residents and or refugees with loans to cover a variety of social needs with concessional interest rates and repayment terms. Examples of these types of loans include loans to cover education costs and assistance for first home buyers. For example, the New Zealand government will provide loans to NZ citizens, permanent residents and refugees undertaking approved courses of study at NZ educational institutions. The loans are interest free if the student remains in NZ, and loans

do not become repayable until the borrower reaches a specified income level. If the borrower leaves NZ, interest is charged at a rate of 6.8% per year. Borrowers are not assessed in the same way that a commercial lender would assess a potential borrower, and ability to repay the loan is not considered in making the loan. Students do sign a “contract” with the government, but it is not clear that this is a contract in the same manner that a loan with a bank is a contract. The “contracts” are enforceable under legislation rather than common law. Repayment of loans is administered through the NZ taxation agency, and payroll deductions are made in the same manner as deductions for income tax. The NZ government recognizes student loans initially at fair value plus transaction costs, and subsequently at amortized cost using the effective interest rate method, less any impairment loss.

The financial reporting of student loans in New Zealand is consistent with IFRSs, and demonstrates that, at least in that environment, recognition and measurement are possible. Staff are aware, however, that other jurisdictions may have difficulty replicating the situation in NZ.

### **Cash advances on grants**

In many jurisdictions, grants are made to reimburse expenses for particular preapproved projects. For example, the European Commission approved a grant to IFAC to develop IPSAS 25, “Employee Benefits”, whereby the EC agreed to reimburse a fixed percentage of eligible costs up to a maximum amount of the grant. In some circumstances, public sector grantors will provide an advance against the grant, effectively providing the grantee with some working capital to enable the project to be initiated. If the project proceeds as planned and eligible expenses are incurred during the period agreed, the advance is used for the eligible project, otherwise it is returned to the grantor, usually with any interest the grantee has earned on funds advanced. These types of arrangements are very common in Europe and other jurisdictions influenced by European financial management practices. In the European Commission this is known as pre-financing and is particularly significant for payments made under the Common Agricultural Policy, and has led to significant financial reporting issues.

In the Netherlands, the Dutch government recognizes cash advances as either current or non-current liabilities, and measures them at their nominal value, even if the grantor charges no interest or a lower than market interest on the advanced amount.

### **Property Tax**

In the Netherlands, municipalities levy local taxes from citizens based on the value of the property at January 1 each year. The local tax law (a binding arrangement) creates a receivable that has characteristics of a financial instrument, since it gives rise to a non-contractual monetary asset of the government and a non-contractual monetary liability of the taxpayer.

Dutch accounting standards require property tax revenue to be recognized at January 1 each year (in line with probably all existing IPSASs) and there is no recognition of the future revenue stream as an asset.

### **Grants for capital expenditure of a tangible asset**

In the Netherlands, if a local government awards a grant to a third party to be spent on the acquisition of a tangible asset, the local government may recognize a financial asset and amortize that asset over the period that the government has a claim on the grant or asset. Financial assets related to grants are recognized if, and only if:

- a. The grant is spent on capital expenditure by a third party;
- b. The capital expenditure serves the public interest;
- c. The grant agreement includes conditions on the way the grant money is spent; and
- d. The third party has to return the grant or the asset if the third party does not comply with the conditions in the contract.

Financial assets related to grants are recognized even if the return of the grant is remote.

### **Public Sector Specific Financial Instruments**

#### **Land lease**

In the Netherlands, some municipalities lease land to companies and to citizens to build on. These are long-term leases, typically lasting for 50 or 75 years. In most cases the lease is permanent. In some municipalities extensive parts of the municipal territory are leased in this way. For example, the municipality of Amsterdam is the owner of almost 80% of the municipal territory and almost all of this land is leased out. Since 1896, Amsterdam has not normally sold land. Revenues from land leases in Amsterdam amount to around €300 million annually. There are two kinds of leases: permanent and temporary. In Amsterdam permanent land leases are the most common.

Dutch accounting standards for local governments require that land under a temporary lease be recognized as an asset of the local government. The asset is measured at the value of the land as at the date it was first leased out. In most cases it would be onerous to gather historical information about the cost of the land. This value is regarded as a proxy for cost. Permanent leases are treated as a finance lease and the land is not recognized on the balance sheet of the local government. There are, however, some disclosure requirements, for example local governments are required to disclose what proportion of property on the balance sheet is leased out and to disclose long term lease contracts.

#### **Inflation linked bonds**

An inflation linked bond is a bond with a contractual principal amount that is indexed to the non-leveraged inflation rate of the economic environment of the issuer, but cannot decrease below par; the coupon rate is below that of traditional bonds of a similar maturity. Inflation linked bonds are only issued by governments (most commonly the US Federal Government) and are – from the perspective of the issuer – for that reason public

sector specific. The US Government recognizes these liabilities at face value less any unamortized discounts including accrued interest.

According to the definition of financial instruments in IFRSs, an inflation linked bond is a financial instrument. It has an embedded derivative that is closely related to the economic risks and characteristics of the host contract.

### **Financing Charges (South Africa)**

In its discussion paper “Financial Instruments” paragraphs .138 - .148 the South African Accounting Standards Board discusses whether public sector entities should distinguish between a financing component and a non-exchange revenue component of a particular receivable where a significant amount of time passes between the taxable (or other) event and the receipt of economic resources embodying service potential (normally cash or cash equivalents). For example, in respect of taxes on deceased estates a number of years may pass between the death of the person owning taxable property, and a cash payment to the taxation authority in respect of taxes. The issue is whether the reporting entity should discount the taxation receivable and recognize less revenue in respect of the taxation, and recognize the balance as interest receivable. This issue has not been determined finally, and has not been fully addressed in IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)”. The initial view of the South African ASB is that entities should determine whether such a delay constitutes a financing arrangement and if so, apportion the receivable between taxes receivable and finance charges receivable.

### **Accounting Policies in New Zealand Dealing with Non-Contractual Binding Arrangements**

The New Zealand government prepares financial statements in accordance with New Zealand International Financial Reporting Standards (NZIFRS). The NZ government also adopts a financial reporting standard equivalent to IPSAS 23, and has developed accounting policies to address the recognition, measurement, presentation and disclosure of items that arise from non-exchange transactions that have the characteristics of financial instruments. The NZ government has adopted an approach in which the definitions of a financial instrument, financial asset and financial liability in IAS 39 are not changed to include non-contractual binding arrangements. However, preparers are provided with guidance on the IAS 39 category into which particular public sector non-contractual binding arrangements are to be classified. The draft accounting policies note that “Although they do not arise out of contract, some government specific items such as taxes and levies receivable, and issued currency, have for ease of presentation purposes been included as a financial instrument.” The draft accounting policies note how certain items are to be accounted for, for example tax receivables and other sovereign receivables are designated as loans and receivables. It has been suggested that application guidance be included in the IPSASB equivalent to IAS 39 to recommend that public sector entities generally, take this approach. Staff are of the view that this might However, there are obvious issues of making global judgments and comparisons.

### **Conclusion**

The experience of the few jurisdictions observed indicates that public sector financial instruments, and non-contractual items with characteristics of financial instruments are measured, subsequent to initial measurement, in one of three ways:

- a. Nominal value;
- b. Amortized cost using the effective interest rate method, less any accumulated impairments; and
- c. Fair value.

Staff are of the view that further examples should be submitted and examined, but that a consultation paper be developed that seeks input on various possible measurement principles in order to develop an exposure draft.

## **Financial Instruments – Rules of the Road Analysis of Recent IFRICs**

### **Summary of IFRIC 2, “Members’ Shares in Co-operative Entities and Similar Instruments”**

In this interpretation the IFRIC examines the issue of co-operative entities and the circumstances when members’ shares in a co-operative entity will be classified as equity. The IFRIC concluded if the entity has an unconditional right to refuse redemption of the members’ shares, or if local law or the entity’s charter imposes prohibitions on redemption of members’ shares, the shares, or that proportion of shares that the entity is prohibited from redeeming, are to be classified as equity.

### **Summary of IFRIC 9, “Reassessment of Embedded Derivatives”**

In this interpretation the IFRIC examines issues relating to the assessment of embedded derivatives in a contract. IAS 39, “Financial Instrument: Recognition and Measurement” requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivatives contained in the contract are required to be separated from the host contract and accounted for as derivatives under IAS 39. The interpretation addresses two issues: firstly, whether IAS 39 requires such an assessment to be made only when the entity first becomes a party to the contract, or whether the assessment should be reconsidered throughout the life of the contract. Secondly, the interpretation addresses whether a first time adopter makes its assessment on the basis of the conditions that existed when the entity first became a party to the contract, or those prevailing when the entity adopts IFRSs for the first time.

The IFRIC concludes that in respect of the first issue, entities should not reassess contracts unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract.

The IFRIC concludes in respect of the second issue that a first time adopter assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first becomes a party to the contract and the date of any change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract.

### **Summary of IFRIC 16, “Hedges of a Net Investment in a Foreign Operation”**

In this interpretation, IFRIC addresses a number of issues related to the hedging of a net investment in a foreign operation, noting that the hedging investment may be held by the ultimate parent entity, or one of its controlled entities. The first issue addressed in the interpretation is whether the parent entity could designate as a hedge the differences arising from the functional currencies of the parent and controlled entity, and whether it could designate as a hedge the differences arising from the presentation currency of the parent and the functional currency of the controlled entity. The IFRIC concluded that differences between functional currencies could be hedged, but not differences between

the presentation currency and the functional currency because this is not a risk the entity is exposed to.

The second issue addressed in the interpretation is whether, if the parent entity holds the controlled entity indirectly, if the hedged risk may include only the foreign exchange differences arising from difference in functional currencies between the foreign operation and its immediate parent, or whether the hedged risk may also include any foreign exchange differences between the functional currency of the foreign operation and any intermediate or ultimate parent entity. The IFRIC concluded that the ultimate parent can hedge the exchange differences between the functional currency of the parent and that of any foreign operation within the group. An intermediate parent can hedge the exchange differences between its functional currency and that of its controlled entity, but not the exchange differences that arise between the functional currency of its foreign operation and its ultimate parent.

The third issue addressed in the interpretation is whether a qualifying hedge accounting relationship can be established only if the entity hedging is a party to the hedging instrument or whether any entity in the group, regardless of its functional currency can hold the hedging instrument. The IFRIC concluded that any entity within the economic entity can hold the instrument, except the foreign operation that is itself being hedged. If the hedging instrument is held by a reporting entity that is not a parent of the foreign operation being hedged, that reporting entity does not report the instrument as a hedging instrument.

The fourth issue addressed in the interpretation is whether the nature of the hedging instrument (derivative or non-derivative) or the method of consolidation affects the assessment of hedge effectiveness. The IFRIC concluded that neither of these issues affects the assessment of hedge effectiveness.

The final issue addressed by the interpretation relates to amounts to be reclassified from equity to profit or loss as reclassification adjustments on disposal of a foreign operation. The IFRIC concluded that when a foreign operation that was hedged is disposed of, the amounts from the parent entity's foreign currency translation reserve in respect of the hedging instrument and in respect of that foreign operation should be reclassified from equity to profit or loss in the parent entity's consolidated financial statements in accordance with paragraph 102 of IAS 39, and paragraph 48 of IAS 21, "The Effects of Changes in Foreign Exchange Rates." The IFRIC also concluded that the amount included in a parent entity's foreign currency translation reserve in respect of an individual foreign operation may be affected by the choice of the direct method or step-by-step method of consolidation. The use of the step-by-step method of consolidation may result in the reclassification to profit or loss of an amount different from that used to determine hedge effectiveness. This difference may be eliminated by determining the amount relating to that foreign operation that would have arisen if the direct method of consolidation had been used. Making this adjustment is not required by IAS 21. The IFRSs require that entities follow a consistent consolidation policy for all net investments.

### *Guidelines for Modifying IASB Documents*

As for all newly initiated IFRS convergence projects, the starting point is an analysis of public sector issues using the IPSASB, “Guidelines for Modifying IASB Documents” (Rules of the Road). These have been applied to IFRICs 2, 9 and 16 to determine the approach to the project, i.e., whether the provisions of these IFRICs should be incorporated into IPSASs developed in respect of IFRS 7, “Financial Instruments: Disclosures”, IAS 32, “Financial Instruments: Presentation” and IAS 39.

#### **Step 1: Are there public sector issues that warrant departure?**

In applying the rules in step 1, public sector issues are assessed to determine if they warrant a departure in recognition, measurement, presentation or disclosure requirements. Staff has identified a number of issues in reviewing the IFRSs from a public sector perspective.. These issues are explored in greater detail in the Issues Paper.

*Rule #1: Where applying the international accounting standards/interpretations would mean the objectives of public sector financial reporting would not be met.*

In respect of co-operatives, public sector entities that have this structure, such as an entity that is co-operatively owned by several local governments in the same geographical area, will also need to identify whether members’ shares are liabilities or part of net assets/equity. The interpretation provided by IFRIC 2 will be equally applicable to public sector entities that are established as co-operatives with member shares.

In respect of the reassessment of derivatives, staff are of the view that there is no need to impose more onerous requirements on public sector entities than those that are applied by entities adopting IFRSs. The IFRSs require reassessment only when contractual terms are amended and those amendments result in a significant change in the projected cash flows. Staff are of the view that in this respect, the objectives of public sector financial reporting would be met by incorporating IFRIC 9 into IPSASs addressing financial instruments.

In respect of hedging of a net investment in a foreign operation, to the extent that public sector entities engage in such transactions, it is arguable that the same financial reporting principles adopted by entities applying IFRSs should be applied to similar transactions in the public sector. Some governments and other public sector entities have significant operations in other jurisdictions that have a different functional currency to the ultimate controlling entity; many entities will have policies in place to manage their exposure to changes in foreign exchange rates. Where entities manage their foreign exchange using financial instruments, the entity should make similar disclosures to those required of entities reporting under IFRSs. Staff are unaware of any public sector specific reason for adopting a different financial reporting regime for what is essentially an identical transaction.

*Rule #2: Where applying the international accounting standards/interpretations would result in a loss of accountability to stakeholders.*

In respect of public sector entities with a co-operative structure with issued shares, staff believe that implementing IFRIC 2 would enhance accountability to stakeholders. This is because it would require entities to examine the substance of member shares rather than

simply reflecting the legal form of shares as net assets/equity. Where an entity cannot avoid repaying equity, IFRIC 2 requires the recognition of a liability.

In respect of reassessment of derivatives, staff are of the view that the implementation of IFRIC 9 would not result in a loss of accountability to stakeholders. Staff are of the view that requiring entities to reassess the classification of derivatives should not be required unless there have been amendments to the terms of the contract that significantly alter the expected cash flows related to the instruments, as set out in IFRIC 9. Requiring reassessment in the absence of amendments to the terms of the contract would be burdensome to entities.

As was noted in the agenda papers for the IPSASB meeting in June 2008, staff acknowledge the view that hedged accounting impairs accountability as it is based on management intention and leads to similar assets and liabilities being measured in different ways depending on whether they have been designated for hedging. This applies to hedging of a net investment in a foreign operation as well as hedging generally. Staff have not, however, identified a robust public sector rationale for treating a like transaction in the public sector differently to the way it is treated in the private sector.

*Rule #3: Where applying the international accounting standards/interpretations would mean the qualitative characteristics of public sector financial reporting would not be met.*

The IPSASB is addressing the qualitative characteristics of public sector financial reporting in its conceptual framework project. The existing IPSASB qualitative characteristics are: understandability, relevance, reliability and comparability.

Staff are of the view that applying IFRIC 2 to public sector entities that are structured as co-operatives would satisfy the qualitative characteristics of public sector financial reporting. In particular, requiring entities to examine the substance, rather than the form, of member shares will enhance the understandability, relevance, reliability and comparability of financial reports by ensuring that all liabilities and net/assets equity of the entity are reported according to their substance.

Staff are of the view that application of IFRIC 9 by public sector entities will mean that the qualitative characteristics of financial reporting will be met. The qualitative characteristics do not require that elements of the financial statements need to be reassessed absent any change in the terms of those elements.

Staff are of the view that application of IFRIC 16 by public sector entities would result in the qualitative characteristics of public sector financial reporting being met to the extent that hedge accounting generally satisfies the qualitative characteristics of public sector financial reporting. The IPSASB has not conclusively agreed that hedge accounting satisfies the qualitative characteristics of public sector financial reporting, notwithstanding that the IASB has concluded that hedge accounting satisfies its qualitative characteristics. The current IPSASB qualitative characteristics are identical to the IASB's qualitative characteristics.

*Rule #4: Where the cost of applying the international accounting standards/interpretations exceeds the benefit.*

Staff acknowledge the view that the IFRSs addressing financial instruments are complex, difficult to interpret and difficult to apply, which leads to higher costs in preparing financial statements. However, IFRICs 2, 9 and 16 clarify the application of the IFRSs to particular transactions, so should simplify the financial reporting of those transactions, thereby reducing the cost of compliance with the IFRSs. Staff are of the view that the benefits of applying the IFRICs would exceed the cost of implementing those interpretations.

**Summary of Step 1 – Analysis:**

Areas of consideration	Issue Identified	Comments
1) Cause objectives of financial reporting not to be met?	Hedging	To the extent that the IPSASB does not consider hedging to be appropriate in the public sector, IFRIC 16 may not be applied.
2) Affect the accountability to stakeholders?	Hedging	If IPSASB decides hedging affects the level of accountability, IFRIC 16 may not be applied.
3) Cause qualitative characteristics not to be met?	Hedging	IPSASB's current qualitative characteristics are identical to the IASB's. If the IPSASB decides that hedging does not satisfy the qualitative characteristics IFRIC 16 may not be applied.
4) Where cost of applying exceeds the benefit.	None.	The IFRICs clarify the application of the IFRSs and should simplify financial reporting, leading to lower reporting costs. Benefits are anticipated to exceed costs.

**Conclusion Step 1:** Staff concludes that there are no public sector issues that warrant a departure from IFRIC 2 and 9. In respect of IFRIC 16, if the IPSASB concludes that it is appropriate to permit hedge accounting in the public sector then there are no public sector issues that warrant departure from IFRIC 16. If the IPSASB concludes that hedge accounting should not be applied in the public sector, IFRIC 16 would not be included in the IPSASs developed to address financial instruments in the public sector.

Therefore in applying the guidelines we need to proceed to step 2.

**Step 2: Are the departures so significant that a public sector specific project should be initiated?**

**IFRIC 2:** Staff conclude that there is no need to develop a public sector project on any issue arising from IFRIC 2.

**IFRIC 9:** Staff conclude that there is no need to develop a public sector project on any issue arising from IFRIC 9.

**IFRIC 16:** Staff conclude that if the IPSASB concludes that hedge accounting is not appropriate for the public sector, then IFRIC 16 would not be incorporated into the IPSASs developed to address financial instruments.

**Conclusion Step 2:** Staff concludes that there are no issues arising from IFRICs 2, 9 and 16 that warrant the initiation of a public sector specific project.

**Step 3: Modify IASB documents**

As noted, staff believes that there are no issues relating to IFRICs 2 or 9 that require modification to the IASB documents. In respect of IFRIC 16, the IPSASB needs to determine whether hedge accounting should be permitted in the public sector.

**Conclusion Step 3:** Staff concludes that IFRICs 2 and 9 should be incorporated into the IPSASs developed to address financial instruments. If the IPSASB concludes that hedge accounting is inappropriate in the public sector IFRIC 16 will not be incorporated in the IPSASs developed for this project, otherwise, as no public sector specific issues have otherwise been identified, IFRIC 16 will be incorporated into the IPSASs.

**Step 4: Make IPSAS style and terminology changes to IASB documents**

The standard changes to the IASB document to reflect IPSAS style and terminology will be made in preparing the ED.

**Matthew Bohun-Aponte  
TECHNICAL MANAGER**

**John Stanford  
DEPUTY DIRECTOR**

CUT AND PASTE OF RESPONSES

Respondent	SP1: Do not modify definitions of financial instrument, financial asset and financial liability to include non-contractual binding arrangements.	SP2: Retain notion of settlement in own equity instruments in definition of financial liability.	SP3: Permit entities to reclassify a FI into or out of the category “fair value through the surplus or deficit” when fair value becomes reasonably determinable or ceases to be reasonably determinable, but no further reclassification is permitted.	SP4: Liaise with EC staff on the approach to determining fair value of a financial guarantee provided at zero consideration.	SP5:Hedging: ED to be drawn primarily from IAS 39 and should reflect current requirements of IAS 39.
Sheila Fraser	Agree – Non-contractual likely to need separate project.	Agree, likely to be very rare in the public sector. Ask respondents if they are aware of any transactions.	Agree.		Have sympathy for the approach, however it will be very important to follow developments in this area to adequately assess them and reflect any changes necessary.
Peter Batten	Support staff’s latest recommendation to defer consideration of non-contractual items until a later date.	Agree. Since retaining these references is unlikely to affect many entities, we are not convinced that a specific matter for comment should be included on this aspect. Identifying it as a specific matter for comment is likely to create the misconception that the IPSASB thinks it is an important issue.	Disagree. We do not believe that there is a public sector reason for departing from the reclassification requirements of IAS 39. IAS 39.53 and IAS 39.54 cover the situation envisaged.	Support staff’s proposal to liaise with the EC. We believe that, in analyzing this issue, a distinction should be drawn between contractual guarantees and the more difficult to measure statutory guarantees (for which there is less evidence to measure the value of a market transaction).	Support the proposal that despite international developments regarding hedge accounting, the ED developed from IAS 39 should reflect the current hedging requirements.

Chris Wobschall (CIPFA)	Agree	Agree.	Disagree. We are not convinced by the proposals for an approach to reclassification which diverges from IFRS. Whilst referring to other discussions and other proposals for divergence, the paper does not provide a public sector rationale for divergence which would be required under the Rules of the Road. Nor, in light of the UK experience, do we see the need for divergence from IFRS.	Agree.	Agree.
Larry White	Agree	Agree	Agree	Agree	Agree
Andreas Bergmann	Disagree. The approach proposed by staff does not provide any value added to the users of our standards. It leaves them with the most difficult but still highly relevant issues to resolve on their own. IF our ED is a mere copy of the IFRS and fails to address the sector specific issues we should drop the project altogether, withdraw IPSAS 15 and refer	Disagree. This approach does not address public sector specific issues.	Agree. There is a minor issue with consolidation, but I agree this is not critical as such issues are common when it come to consolidation.	Agree. Suggest contacting any IPSASB members or TAs who are in ministries of finance for advice as well.	Agree. This is a rules of the road question. The question is whether there are any public sector specific reasons to depart from IAS 39. If such reasons exist, FASB might be another source to which we could refer, if not I don't see any reason why we should shift from IAS to FASB. I support proposal so as not to depart from the rules of the road.

	users to the hierarchy. If the previous direction by the IPSASB is impossible, the convergence part of the project should be withdrawn.				
Rick Neville	Agree.	Agree. I do not recall ever seeing any transaction in the public sector settled in own equity instruments, however I believe it wiser to leave it in than have an issue with consolidation later.	Agree. Have a concern on how we are going to accomplish this or “operationalize” this reclassification, when appropriate to do so. Further discussion on this point might be in order. GBEs would continue to apply IAS 39.	Noted, I look forward to hearing the results of these deliberations.	Support staff proposals. However staff should continue to monitor the IASB’s discussion paper and the FASB’s ED for any new developments and ensure that our workplan remains flexible enough to respond to how hedge accounting provisions may be amended.
Tadashi Sekikawa	Agree.	Disagree, it would be extremely rare circumstances where entities that apply IPSASs issue such types of FI. I do not think the consolidation case justifies the retention of the definition in IAS 32 since entity’s own equity in the consolidated FS means equity of the controlling entity, not controlled entities.	Disagree, I do not find any public sector reasons for departure.	Noted.	Agree.

<p>Greg Schollum</p>	<p>Agree. I do, however, think it will be important to clarify in the guidance material that these items are not within the scope of the resulting IPSASs based on IAS 32, and IAS 39, to avoid any confusion.</p>	<p>Agree.</p>	<p>Agree. This is a sensible improvement on the IFRS position which is heavily influenced by a ‘rules based’ approach.</p>	<p>Agree.</p>	<p>I would like to see if we can be a little more radical and try and simplify the hedge accounting requirements. Hedge accounting is one of the most complex and “rules based” sections of IAS 39 and, therefore, represents a significant opportunity for improvement. I don’t propose that the IPSASB should change the underlying principles of hedge accounting.</p>
<p>Frans Van Schaik</p>	<p>Agree. Including non-contractual binding arrangements would require considerably more time to prepare an IPSAS on recognition and measurement. We would welcome a separate research project starting now into the wide ranging implications of including non-contractual binding arrangements in to the financial instruments definition.</p>	<p>Agree</p>	<p>Disagree, the public sector reason to deviate from IFRS is unclear.</p>	<p>Noted.</p>	<p>Agree.</p>

<p>John Verrinder</p>	<p>The main area of interest for statisticians is in “non-contractual items with characteristics of financial instruments.: Statisticians include these items in the “financial instruments” in statistics – they are intended to fully account for the difference in timing of the economic event and the settlement, otherwise our economic accounts would not balance from non-financial and financial perspectives. The amounts involved, at least in Europe, are large and some governments are trying to use the “assets” in inventive ways (e.g. securitization, though this now appears to be drying up).</p> <p>There is a danger of this slowing the project down, however, there is also a question of adding value in the public sector.</p>		<p>It is interesting to note that in Europe a high proportion of governments’ financial assets are in the form of shares and other equity, much of this in public corporations (also in some countries holdings of shares by social security funds). There are challenges to determine a “market” value of this equity when it is unquoted, nevertheless the available accounting data (at least for larger public corporations) are abundant, so getting to book value (with an accurate value for shareholder reserves) should at least be better than a cost-based approach. The challenge in the staff proposal will be to define “reasonably determinable” in these circumstances; perhaps there are lessons to be learned from valuation of private equity?</p>		
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