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Per e-mail

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Dear John,

COMMENT ON THE CONSULTATION PAPER ON PUBLIC SECTOR SPECIFIC FINANCIAL INSTRUMENTS

We welcome the opportunity to comment on the Consultation Paper on *Public Sector Specific Financial Instruments.*

The views expressed in this letter are those of the Secretariat and not the Accounting Standards Board (Board). In formulating our comments, the Secretariat consulted with a range of stakeholders including auditors, and preparers at the National Treasury and the South African Reserve Bank (which is the central bank in South Africa).

We are supportive of the development of guidance on notes and coins in circulation, monetary gold, Special Drawing Rights and subscriptions in the International Monetary Fund (IMF) as this will ensure that jurisdictions consistently account for these assets and liabilities.

We have three overarching concerns that we believe should be considered when progressing the development of guidance for these transactions:

- We are of the view that greater consideration needs to be given to assessing whether some of the assets and liabilities in the Consultation Paper in fact meet the definition of a financial asset or a financial liability. We believe that some of them meet the current definition of a financial instrument, i.e. subscriptions in the IMF and Special Drawing Rights, while others could meet the definition of a financial instrument if appropriate adjustments are made to the existing definitions of financial instruments, i.e. monetary gold and notes and coins in circulation. If these instruments are in fact financial instruments, guidance on their recognition, measurement, presentation and disclosure could be included in the newly revised IPSASs on financial instruments instead of developing new guidance.

- In many of the accounting options discussed in the Consultation Paper, particularly in relation to where items are recognised, we believe that the options selected by respondents may be influenced by first time adoption issues and the ongoing recognition of items. This is particularly the case for the revenue approach proposed for notes and coins in circulation. For example, some of our constituents could support a revenue approach on an ongoing basis, but only if, on initial application of the guidance, the revenue for the initial recognition of the notes and coins in circulation was adjusted to accumulated surplus or deficit in comparative periods. Greater consideration will need to be given to the entries on initial adoption versus ongoing recognition and measurement in the next phase of the project. Consideration will also need to be given to where gains and losses on changes in the value of the underlying instruments are recognised, i.e. statement of financial performance or the statement of changes in net assets/equity.
- Many of the transactions in the Consultation Paper are recognised and measured by central banks, many of whom apply International Financial Reporting Standards (IFRSs). With the publication of this guidance by the IPSASB, it may be possible, through the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors,* for these entities to consider the guidance in the IPSASs. To ensure that the guidance is used to its fullest extent, it may be useful to engage with the IASB to understand whether the guidance is in fact compatible with IFRSs and how it could be used by entities that report using IFRS.
- Many of the central banks are governed by specific legislation. The legislation may also include specific requirements relating to the measurement of items and/or how/where changes in the underlying values of those items are recognised. Where legislation is explicit about these issues, central banks will be required to follow the relevant legislative prescripts rather than any accounting standard. It may be useful to deal with this issue in whatever guidance is issued as part of the next phase of the project. In particular, it should be clear that where the legislative prescripts are applied in accounting for transactions, the central bank/government department will need to assess the impact of applying these requirements on compliance with the reporting framework.

Our detailed responses to the specific matters for comment and preliminary views are outlined in Annexure A to this letter.

Please feel free to contact me should you have any queries relating to this letter.

Yours sincerely

Jeanine Poggiolini, Technical Director

ANNEXURE A – DETAILED COMMENTS

Chapter 2 – General Definitions

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?

We support the general definitions proposed for "monetary authority" and "reserve assets". In the South African context, it is the South African Reserve Bank (central bank) that is the monetary authority.

We do however believe that the following improvements could be made to the explanations supporting the definitions:

- An explanation of "balance of payments" may be helpful to understand the nature and intended use of reserve assets. It may be useful to consult the Balance of Payments manual to develop an appropriate explanation.
- An explanation should be included of "highly liquid investments". In particular, it would be useful to know if it is the same concept as in the other IPSASs.
- The current definition of reserve assets refers to "external assets" as those assets that have a foreign (non-resident) counterparty.
- The wording in the second sentence in paragraph 2.6 should be reworded. It is possible that there is a counterparty for physical gold, e.g. if gold is held by another party. We would suggest that the sentence is reworded to make it clear that there "may or may not" be a counterparty for physical gold.

Chapter 3 – Currency in Circulation

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

Definition is as follows:

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

Do you agree with the IPSASB's Preliminary View – Chapter 3-1?

We support the proposed definition of currency in circulation.

Questions were however raised by respondents about a specific scenario in Zimbabwe and how this is captured in the proposed definition. This scenario is outlined below.

Zimbabwe uses the US dollar as its legal tender. The Reserve Bank of Zimbabwe recently announced that it will issue "Zimbabwe Bond Notes". From available information, it seems as if these notes will be issued by the Zimbabwe Reserve Bank, but will be denominated in US dollars (i.e. the par value of the note is equivalent to the value of the US dollar). The notes will be denominated in 2, 5, 10 and 20 US dollars. The notes are backed by a USD 200 million facility with a foreign bank. The Zimbabwe Reserve Bank also issues "bond coins" which facilitates the provision of small change when purchasing goods.

While this situation is not specifically discussed in paragraph 3.7 and 3.8, we assume that the Zimbabwe Bond Notes would be regarded as currency in circulation and would be a liability for the Zimbabwe Reserve Bank. The US Dollar notes issued by the US government would be a liability for the Federal Reserve.

When developing the guidance on currency in circulation, it might be useful to discuss this example as it is yet another scenario that jurisdictions may encounter in adopting IPSASs.

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

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?

Recognition of a liability

We support the preliminary view that both notes and coins give rise to a liability for the issuer. The Consultation Paper outlines a number of obligations (either legally or non-legally binding) that may indicate that notes and coins in circulation give rise to an obligation of the central bank. While we do not disagree with this discussion, we believe there is a more fundamental question to be asked, and that is whether notes and coins in circulation are a financial instrument, and more specifically, a financial liability.

The definition of a financial asset includes "cash" held by an entity. We would argue that the opposite side of this transaction, which is the cash issued by the central bank, is a financial liability. Apart from this notion, we also believe that notes and coins in circulation otherwise meet the definition of a financial instrument because it is a contractual arrangement between the holder and the issuer of the instrument. The actual banknote or coin represents the contractual arrangement between the holder of the note/coin and the central bank.

We believe that the treatment of notes and coins in circulation as financial instruments provides far great clarity and consistency in the accounting. The approach currently outlined in the Consultation Paper, which seemingly allows entities or jurisdictions to decide if they have an obligation (either legally or non-legally binding), does not provide the correct conceptual answer and will result in diversity in practice. It also seems to focus on the government's obligations to "issue and maintain" currency, and seems to ignore the accounting consequences of the "legal tender" notion associated with notes and coins.

While we appreciate that the current definition of a financial liability does not include cash issued by an entity, we believe the existing definition should be modified based on the rationale outlined above.

Measurement of the liability and other issues

<u>Measurement of notes and coins in circulation</u>

Three measurement approaches are discussed in the Consultation Paper – historical cost, cost of fulfilment and market value.

As noted in our opening remarks, it is important to distinguish between initial measurement and subsequent measurement. The Consultation Paper currently does not make such a distinction.

We believe that market value is the most appropriate measurement basis because the value of notes and coins cannot be higher than the face value of the note. We believe that market value, which is "the amount for which a liability can be settled" best represents this concept.

We do not believe that historical cost and cost of fulfilment are appropriate measurement bases for the reasons outlined below.

- Historical cost – while historical cost represents the consideration received in the transaction, which may also represent the face value of the notes, it is unclear how transaction costs would be treated. Typically in historical cost measurement bases transaction costs are capitalised to the cost of the transaction. If this is the intention, then we do not support the use of historical cost.
- Cost of fulfilment – cost of fulfilment represents the "costs that an entity will incur to fulfil the obligation in the least costly manner", which would typically reflect the cost of producing the notes. Based on our comments on the nature

of the liability related to notes and coins, we do not believe that cost of fulfilment is appropriate as it focuses on the “maintenance” of the currency. In addition, once the currency is issued there is a different obligation that arises that needs to be measured, which is a higher amount than the cost of replacing the notes and coins.

Issuing of currency

While we support the proposed accounting treatment for the issuance of currency, we believe it may be necessary to provide guidance on where to recognise the deficit if the production costs of coins are higher than their face value. Consideration would also need to be given to whether an onerous contract exists, and when it should be recognised.

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

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

(i) Statement of financial performance; or
(ii) Statement of net assets/equity?

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

Based on our comments to Preliminary View 3-2, we do not believe that it is possible that the issue of notes and coins does not give rise to an obligation for the central bank (or government).

However, if this alternative approach is pursued, we have the following comments:

- The approach proposed focuses on where to recognise revenue. We believe it is inappropriate to recognise revenue directly in the statement of changes in net assets.
- If the proposal is to directly recognise the gain from issuing the notes and coins in the statement of changes in net assets/equity, we believe that this supports the idea that the notes and coins in circulation is some kind of “inventory of goods” that are maintained with the credit side of the transaction being some sort of “capital” that is maintained in net assets/equity. This is not the same view as treating notes and coins as revenue and expense transactions, which is more closely aligned with the idea that the issue of notes and coins are part of the central bank’s normal operating activities.
- We believe that recognising the gain from issuing notes and coins could be better suited to the statement of financial performance, if a clear distinction is made between accounting on initial adoption of the guidance (which would require retrospective restatement with adjustments to previously reported accumulated surplus and deficit), and accounting for new issues of notes and coins. This approach could be justified on the basis that the issuing of the notes and coins is part of the central bank’s ordinary operating activities.

- If the revenue approach as outlined in the previous bullet is supported, we believe that appropriate derecognition guidance would also need to be provided on the accounting when notes and coins are removed from circulation.

Chapter 4 – Monetary Gold

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?

We support the definition of monetary gold and the related discussion.

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

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.

<u>South African context</u>

From a South African perspective, the measurement of gold and the related gains and losses, is measured based on the prescripts of the South African Reserve Bank Act. This Act requires that:

- gold is measured at the statutory price, which is the equivalent of the spot price at reporting date; and
- gains and losses arising from price and foreign exchange movements are recognised in a specific way (partly in the statement of financial performance and partly in an account on the statement of financial position called the "gold and foreign currency contingency reserve account").

As the measurement of gold along with recognition of gains and losses on movements in the gold price is legislated, the requirements outlined in any IPSAS regarding gold will not be applied in South Africa. Although the requirements of any IPSAS on this issue will not be applied, we have specific views about how gold should be measured.

<u>Response to Specific Matter for Comment</u>

We do not believe that entities should apply a different measurement basis depending on their intention for holding gold. In particular, the Consultation Paper notes that market value is appropriate if an entity holds gold for its "financial capacity", while historical cost is appropriate if gold is held to deliver "services" (such as providing stability and confidence in the market).

We believe that monetary gold should be measured at market value as it is an item that can be seen as near to cash. Using any other basis does not provide useful information to users of the financial statements. We also believe that using market value fulfils both the measurement objectives of providing information on the entity's financial capacity and cost of services. In particular, if the entity had to replace or acquire new gold for "service delivery" purposes, the price paid would be the market value at that time. Therefore market value rather than historical cost is a better measure of cost of services.

While we believe that a single measurement basis should be applied, i.e. market value, we believe that there may be an argument for recognising the gains or losses on revaluing the gold differently depending on why the entity holds gold. For example, an entity may hold some gold for sale, while the rest may be held to ensure confidence in the economy. In these instances, we believe that it may be appropriate to recognise the gains or losses on the gold held for sale in surplus or deficit, while the gains or losses on the remaining gold could be recognised in net assets/equity.

The Consultation Paper indicates that users are interested in the quantity of gold if the historical cost basis is used. We believe this is useful information irrespective of the measurement basis applied and would encourage the IPSASB to require the disclosure of this information when guidance is developed.

If the historical cost view is progressed in the next phase of the project, guidance would need to be given on whether gold should be impaired, how this should be accounted for, and how any impairment losses would be reversed.

We also urge the IPSASB to consider whether monetary gold is in fact also a financial instrument. Although not defined as a financial instrument in the current definitions, we believe it has the same features and characteristics of cash, is easily and readily convertible into cash, and is often used as a method of denominating transactions between central banks and governments. It is however important to note that IFRS 9 paragraph IG.B.1 refers to gold as a "commodity". This would need to be revised if monetary gold is considered to be similar to cash.

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

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).

See our comment to Specific Matter for Comment 4-1. We do not support using historical cost for monetary gold.

Chapter 5 – International Monetary Fund Quota Subscription and Special Drawing Rights

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?

As the definitions are aligned with the Government Finance Statistics Manual issued by the International Monetary Fund, we support the proposed definition.

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

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?

We support the accounting proposed in the Consultation Paper for IMF subscriptions, as well as SDR holdings and SDR allocations.

We do however believe that these meet the current definition of a financial instrument and would urge the IPSASB to include these instruments in the current guidance on financial instruments. This would mean that some guidance may need to be provided for the measurement of these instruments to ensure that what is proposed in the Consultation Paper is consistent with fair value in relation to the measurement of financial instruments.

In our discussions with the National Treasury, it was observed that there are other subscriptions that are paid to other organisations that are, in substance, no different to the subscriptions in the IMF. For example, contributions to the African and Asian Development Bank are similar in nature to the subscription paid to the IMF. As a result, we believe that the accounting could be described more generally, and examples used to illustrate the accounting, rather than focusing the accounting specifically on transactions with the IMF.