

# IPSASB Consultation Paper

## Public Sector Specific Financial Instruments

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#### Submission by

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## Introduction

The authors of this submission compliment the IPSASB for the initiative in preparing this consultation paper on public sector specific financial instruments. Although the consultation paper potentially covers the whole public sector, the major impact will be on the monetary authorities, and, in particular, on central banks. These authorities use financial instruments in the discharge of their delegated functions and thus with different objectives to other public or private sector entities. We will discuss such policy assets (and liabilities) further in this paper. Our comments in this response apply in the context of central banks and not to the wider public sector. We note that the conceptual framework to IPSAS encompasses the principle that the financial statements should be specific to the reporting entity. We thus consider our approach to be consistent with this principle.

Although the consultation paper covers some specific financial instruments, the authors consider that a proper consideration of the issues involved requires an understanding of wider issues affecting central bank accounting. Accordingly, we have included such a discussion in our submission, before commenting on the specific questions asked in the consultation paper. The authors have also expanded on the issues in these sections of the submission.

The authors work in the field of central bank balance sheet structures and financial reporting. Hence the comments are in the context of central banking, the authors' area of expertise, but with the expectation that they will apply to the broader public sector. The authors have an interest and expertise in the use of, and accounting for, the financial instruments covered by the proposed IPSAS<sup>1</sup>.

## Summary

The authors welcome the consultation paper (CP), and believe that it offers a critically unique opportunity to provide a more comprehensive reporting framework:

- for public sector entities who hold and use financial instruments to achieve designated policy goals, in a manner quite different from profit maximizing entities,
- That is an internationally consistent model of best practice financial reporting for those public policy entities who lack the ability to create their own reporting frameworks that are more appropriate for their needs than the national GAAP,
- That central banks can adopt and provide a model of transparent reporting for other policy or non-profit maximizing public sector entities to follow.

The hope of these comments is that IPSASB use this opportunity to provide a more substantive guidance for central bank financial reporting. The main, but not only, standards

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<sup>1</sup> The authors acknowledge that IFRS, and the ESCB accounting guidelines, form the basis for their consultation paper comments as these are the accounting frameworks that they are most familiar with, and which are widely adopted by central banks. However, this is not to be taken as an endorsement of these as an optimal central bank accounting framework.

affected by such a move will be IPSAS 29 Financial Instruments-Recognition and Measurement and IPSAS 4 The Effects of Changes in Foreign Exchange Rates.

The first point is to clarify that these proposed IPSAS will apply to the individual public sector entity, or entities concerned who need to be able to report on how they have used these instruments to achieve the policy objectives specified in the laws defining their functions. Each entity should apply these to their own specific situation without considering other entities in the wider public sector, whose reasons for holding and using financial instruments may vary. In the event of an expanded framework to encompass the policy function of financial instruments, central banks are likely to be the first adopters. Their financial reports could provide examples to other public sector entities, such as treasuries, disaster funds and sovereign wealth funds.

From a whole of public sector perspective, the issue doesn't matter as in consolidated financial statements the individual entity is irrelevant. However, when considering the separate entities<sup>2</sup> that form the "public sector" the issue is critical from perspectives of independence, transparency and accountability. The issue is most important when discussing IMF membership. In this the concepts of "member", "agent", and "principal" impact accounting considerations regarding who carries the risks and rewards of IMF membership. Also, a range of entities, such as the treasury, central bank, or sovereign wealth fund may hold monetary gold as part of official reserves and so any accounting framework must apply across all.

A second point is that the proposals only discuss the balance sheet treatment without discussing the corresponding income recognition issues, and in particular the treatment of revaluation gains and losses. For central banks and their relationship with the ministry of finance, this issue is a matter of great significance. The authors consider that it is inappropriate to decide on the accounting treatments to be followed for financial assets and liabilities without including the income recognition issues.

In terms of the specific questions asked, the authors have reservations and disagreements on several items. The authors consider that more detailed analysis of the wider issues is required and that the treatment of financial instruments used in policy implementation needs to be considered. The authors propose that a category of 'policy' assets be created to supplement the existing categories. The accounting treatment of these should be similar to Fair Value Through Other Comprehensive Income or the current Available for Sale, with foreign exchange revaluations attaching to these instruments receiving the same treatment.

## Objectives of Central Bank Financial Statements

Transparent financial statements are an important element of the central bank's reporting and accountability framework within the broader framework of central bank independence. Reformers saw a heightened level of accountability as a key element in resolving the democratic deficits arising from central bank independence. As profit maximization is not a relevant criterion for reporting central bank performance, the question exists as to what is the

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<sup>2</sup> As is the intention as expressed in the conceptual framework

objective of central bank financial reporting. In the authors' view, there seems to be three prime functions of central bank financial reports:

- Functional performance
- Fiduciary use of delegated public resources in defence of financial independence.
- Determination of distributions to stakeholders, usually, but not universally, the government. This involves a trade off with capital maintenance issues.

It is worth noting that the users of central bank financial statements are not confined to the jurisdiction concerned, but extend to overseas jurisdictions, including international development agencies. In many jurisdictions, the central bank is, or has been, the only public sector entity publishing financial statements. In this context, central bank disclosures have provided a model of best practice for banking entities in their jurisdictions. However, this should not provide any justification for requiring central banks to follow the same accounting framework where the use of financial assets differ.

## Central Bank Accounting Issues

### Accounting frameworks and central bank operations

As previously stated, central banks will potentially be the prime adopters of the accounting treatments proposed in the consultation paper. Central banks have long had specific laws which have included accounting and profit distribution arrangements. These have been expanded with the advent of independent central banks with a price stability mandate and the default practice has been for central banks to have specific laws governing their constitution, functions, operations and powers.

It is common for the laws to specify a reporting framework considered appropriate for an entity working with financial instruments in financial markets. These central bank laws commonly reference IFRS. The external audiences reading the statements regard the use of a recognised accounting framework as an important element of transparency and accountability. This has been one of the factors encouraging the widespread adoption of IFRS despite its shortcomings as an effective central bank reporting framework. The limitations of, and wide variations in national GAAP, and the absence at the time of any widely accepted international accounting framework for central banks, prompted the ECB to develop its own European System of Central Banks (ESCB) accounting guidelines. These guidelines contain material and important divergences from IFRS and IPSAS but reflect the priorities of central bank reporting.

Many central banks use a combination of IFRS and provisions from their central bank law as their accounting framework.<sup>3</sup> The result is a plethora of accounting practices that include national standards through to full IFRS and multiple versions of hybrid adoption to suit perceptions of central bank uniqueness for whatever political or functional reason. The one common trait is the desire to exclude unrealized revaluations from profit and loss.

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<sup>3</sup> For example, the 2015 Reserve Bank of Fiji audit opinion states “Directors and Management are responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards and with the requirements of the Reserve Bank Fiji Act”.

To the authors' knowledge only the Reserve Bank of New Zealand adopts IPSAS as its reporting framework. It would be useful to know the extent of the research and consultation that has been held with central banks as opposed to general government.

### Central Bank use of financial instruments

Central banks can potentially use financial instruments for several purposes, principally:

- (i) To achieve delegated policy objectives, the core of which are:
  - a. Investment of the country's foreign exchange reserves.
  - b. Implementation of exchange rate policy by intervention in the markets, which involves purchases or sales of foreign currency for domestic currency.
  - c. Managing liquidity and interest rates in the domestic market. There are a variety of techniques used, including loans and deposits, and outright sales and purchases of financial instruments. Derivatives may also be used. Although most of the financial instruments used are denominated in domestic currency, foreign currency may be used. Operations are performed on both the asset and liability side of the balance sheet.
  - d. Liquidity assistance to commercial banks, both short term, and longer term as part of a bank rescue.
- (ii) Quasi fiscal activities
  - a. Loans and special securities of the government and other public sector entities for budgeting or developmental purposes. These may be at sub market interest rates, be non-marketable and intended to support the government fiscal or developmental objectives
- (iii) Own funds portfolio to generate income.
  - a. Portfolio of government securities that can also serve as monetary policy instruments

Although the financial instruments are often similar to those used by other financial institutions, the purposes for which they are held are different. Except for category (iii) above, profit is not the motive. In (i) any profit optimization is subservient to its functional objectives with no consideration of conventional liquidity and security criteria. Indeed, a central bank should not be constrained by its accounting policies when conducting these operations. A central bank that puts its own financial position ahead of its policy responsibilities risks failing in its responsibilities. The financial instruments in these categories are being held, and transactions conducted, primarily for policy purposes. Hence policy effectiveness should take precedence over accounting convention. For central banks this can result in the outcome of "good" losses and "bad" profits.

One of the characteristics of such policy operations is that it is the cash flow created by the operation that is important, that is the injection or removal of liquidity from the domestic economy. The importance of the cash flow is emphasised by the fact that internal reporting and external reporting for policy purposes (such as weekly or monthly statements) are often

prepared on a ‘flow’ basis. Revaluations, accruals and other accounting adjustments are ignored for these purposes, as just representing noise.<sup>4</sup>

## Unrealized revaluations

The treatment of unrealized revaluations has been a central driver for central banks to seek their own reporting framework. A common feature of central bank financial statements before the move to adopt some version of GAAP was the use of historic cost. Where central banks used market values, the default practice was to report the revaluations directly to equity rather than through profit and loss. This practice served two purposes.

First, central banks should only make distributions only out of realized income. The exclusion of unrealized earnings from distributions has two purposes:

- (i) Central banks’ balance sheets often carry large open foreign currency positions that produce large and volatile revaluation balances. Central banks seek to hold these balances as buffers to counter the cyclical nature of exchange rate movements. If distributed, unrealized revaluations are not available to act as buffers against subsequent reversals of exchange rate movements.
- (ii) As developed below, distribution of unrealized revaluations represents free credit to government, an action deemed as directly conflicting with a central bank’s price stability mandate. It also results in a reduction in the central bank’s real assets.

Second, the use of historic cost has a logical consistency as central banks have control over the main drivers that determine market price changes, interest and exchange rates. Historic cost lessens any incentive for central banks to game the balance sheet. While this is not common, the authors have seen specific instances where central banks have manipulated exchange rates to achieve specific balance sheet outcomes, unrelated to any functional objectives. The authors recognize the superior benefits of transparency and so do not support the sole use of historic cost but the manipulation of market values does highlight the risks in an uncritical adoption of a profit maximizing GAAP when designing central bank financial statements. A further consideration is that central banks can be dominant players in certain markets and thus the market prices may not be particularly relevant or realistic (see discussion of monetary gold).

A related risk is the situation where the implication for profit and loss, including disclosures, impact policy decisions. Specific situations observed of this are, i) foreign reserves investment committee’s truncating foreign currency portfolio optimal durations due to the impact of exchange rate volatility on profit and loss, and ii) central banks downscaling the level, or structure of, monetary policy operations due to the level of reported losses that would have resulted from a technically appropriate framework. Both are cases of the accounting tail wagging the policy dog.

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<sup>4</sup> Accruals differ from revaluations because of their greater certainty but are ignored as they tend to be immaterial from the policy perspective

Some of these outcomes will be inevitable regardless of the accounting framework adopted, so central banks will always face the challenge of explaining “good losses and bad profits”. However, it seems that many of the world’s central banks, who are unable to develop their own reporting framework, may benefit from having a centrally agreed framework that achieves the undeniable benefits of an internationally recognized accounting framework while mitigating the most egregious features of existing for profit entity accounting frameworks.

The authors raise this issue as it is becoming a pressing issue for central banks. Following the global financial crisis (GFC) central bank balance sheets have expanded with an increase in the open foreign currency position for many central banks. This exacerbates the volatility being reported through profit and loss and is driving central banks to seek alternatives as they believe that the volatility detracts from the ability of the statements to report the substance of functional performance. In some situations, individual central banks are compiling their own modified GAAP reporting frameworks. Unfortunately, these frameworks may lack the collective strength or wisdom of the ESCB’s accounting guidelines. This risks eroding the strength of their independence that the adoption of an independent, internationally agreed, financial reporting framework supported.

### Volatility in accounting statements

The functional obligations delegated to central banks presents specific reporting challenges and balance sheets that test the relevance of existing reporting frameworks. The medium-term focus of a price stability mandate limits the effectiveness of an annual reporting time frame. Imbalances within a balance sheet defined by the requirements of their delegated functions expose banks to a volatility that clouds the ability of financial statements to report functional performance and presents obstacles to optimal policy stances.

Beyond the performance “noise” presented by unrealized revaluations the existence of large portfolios of demand liabilities, principally currency in circulation and commercial bank reserves requirements and correspondent accounts, limits the scope for the adoption of fair value accounting on the liabilities side of the balance sheet. The asymmetrical application of fair value to the asset side of the balance side produces an accounting volatility that obscures the effectiveness of financial statements in reporting performance.

The considerations governing the accounting for financial instruments differ from those for commercial banks and other entities, in two respects (i) on the foreign exchange position and (ii), on the concept of the business model. The current accounting standards in the form of IFRS have proved difficult to apply in some respects. These problems have existed for many years.

Unlike commercial banks and other entities, where the foreign exchange position is a management choice and thus the effects of revaluation can reasonably be included in income, central banks are obliged to hold a foreign exchange portfolio as part of their functions. The resulting exchange rate differences are consequences of policy and not of management.



Consequently, in the authors' view these should not be included in income but in Other Comprehensive income, with recycling when realised<sup>5</sup>.

Turning to the issue of the business model, the real issue which concerns the authors is the inappropriate recognition of unrealised price revaluations in income. This issue in practice revolves around the accounting treatments. Accounting on the basis of amortised cost or FVOCI avoids this problem which only arises when adopting FVTPL for assets. However, full fair value accounting, FVTPL, is not necessarily appropriate, as it means revaluation gains and losses are recognised immediately through profit and loss. For example, the effect of a change in interest rate will be an immediate impact on income through market value changes, particularly with regard to the domestic assets used in monetary policy operations. This does not truly reflect the central bank's economic intention regarding these assets as these are not assets held for trading. It may also impact on policy if CBs take this into account when deciding on interest rate changes. Whilst most of the assets affected have been relatively short term, the effect has not always been material. However, moves to longer term operations in recent years have exacerbated this problem.

Central banks have managed to apply IAS39 reasonably successfully but have had problems with justifying the amortised cost treatment under IAS 39 (the Held-to-Maturity category), as the nature of policy operations means that central banks potentially need to be able to mobilise all assets (i.e. be free to sell them) for policy purposes. The problem is mitigated under IAS 39 as the default (residual) category is AFS and many central banks have adopted this for a large part of their portfolio.

The situation is likely to be less satisfactory under IFRS 9, which places more emphasis on the business model and only has 3 categories for this (held for collecting cash flows, held for cash flows and sales, and other). None of these 3 categories really fit the way central banks use and manage their assets and liabilities) used in monetary policy. Whilst it is possible to fit many of the assets held by central banks into these 3 categories albeit with some difficulties, the position for the domestic (monetary) policy assets is difficult as they do not fit easily into any of the three categories. Whilst it is possible that central banks may be able to make more use of the amortised cost treatment under IFRS 9 than under IAS39, a positive development, the FVOCI treatment, which is broadly equivalent to the former AFS, will be more difficult as it is no longer the residual category. This is now FVTPL. Therefore, central banks may find themselves forced to adopt this category and thus increase the unrealised revaluations included in income.

A further issue arising with IFRS9 is that of Expected Credit Losses with CBs potentially being forced into earlier recognition of provisions against their own, and other, government securities and of loans made to support banks. Here the issue is that the earlier recognition may have implications that are undesirable for policy and may even defeat the intent of the policy operations,

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<sup>5</sup> Permanent losses should be considered as realised.

## A Proposed solution

**The authors therefore suggest that an additional category be created of assets held for policy purposes to cover price and, where necessary, foreign exchange<sup>6</sup> movements related to these instruments.**

As argued above, the authors believe that the requirement for central banks to report unrealized revaluations through profit and loss detracts from the effectiveness of central bank financial statements while also negatively impacting on policy choices. A tension exists between transparency and policy efficacy. The authors are not advocating a move to historic cost or the non-disclosure of revaluations. An effective alternative would be to allow central banks to report unrealized price and foreign currency foreign exchange revaluations from policy instruments as FVOCI. This approach is consistent with the treatment of non-monetary assets under IAS 21. Central banks would recycle realized earnings back through profit and loss. In such situations concepts of realization and realized gains and losses have a specific technical dimension that may be included in a standard or left for central banks to define as accounting administration policy. Under IPSAS the relevant statement is Statement of Changes in Net Assets/Equity

**The standard will need to make provision for situations where unrealized losses exceed any balance in the revaluation reserve**

Such a treatment seems to constitute a minimum departure from existing IFRS/IPSAS standards but would resolve the major substance of central bank demands for a separate accounting standard.

## Disclosures

Functional obligations may limit central bank's ability to meet the full disclosure requirements of standards covering financial instruments. Its role of lender of last resort and financial stability responsibilities requires it to extend credit to stressed financial entities. Disclosure of the details of some of the arrangements that these responsibilities require the central bank to undertake, may be counterproductive, as they may generate the very bank runs or other unwelcome effects, that the lending was intended to prevent. In some cases, the timing of the disclosure is the issue and central banks may feel able to disclose the information at a later date.

Where disclosure of forward-looking information is required central banks need to be careful of giving information that may be policy related or be interpreted as such. For example, disclosure of future interest rates used in valuing assets or liabilities can be interpreted as official policy forecasts.

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<sup>6</sup> Although domestic monetary policy operations are usually carried out using instruments denominated in local currency, this is not always the case. For example, foreign exchange swaps are used by some central banks as a domestic policy instrument

## An entity or instrument specific standard?

Para 7.11 in the IPSAS Conceptual Framework refers to entity-specific measures that may reflect the economic and current policy constraints that affect the possible uses of an asset. This submission does not believe that the problems are necessarily entity-specific. The financial instruments causing the problems are generic to financial markets. Rather it is their use as policy instruments that create specific reporting issues and hence accounting needs for central banks.

Hence this submission argues for an accounting framework that reflects the policy focus implications of central bank use of a range of financial instruments rather than a central bank specific accounting framework.

## The Consultation Paper

### Completeness of the proposals

The commentators believe the CP offers a good base from which to refine the discussion on the specific instruments and expand the discussion to provide a comprehensive reporting framework for public sector entities. Several features in the proposals suggest a gap in comprehension of some of the intricacies of central banking financial operations and accounting.

The first such example of the gap in comprehension is in the definition of the roles of monetary authorities. This does not recognise monetary policy which involves adjusting the level of interest rates and liquidity in the market. Although there is a mention of liquidity, it does not make clear that this is liquidity in financial markets and not the liquidity of the entity itself, as would be the case for other public sector entities. There is no mention of other responsibilities of central banks such as supervision of banks, other financial institutions and of financial stability work. A further nuance is that for central banks, domestic and foreign currency liquidity have materially different meanings and significance

Central banks can create liquidity in their domestic currency but cannot do so in foreign currency.

At this point it is worth noting that many central banks are not actually owned by the state although they typically operate as part of the public sector generally and the lion's share of any profit distribution goes to the state. This reflects the reality that the bulk of central bank earnings consist of profits from monopoly rights delegated by the government. Therefore, a more extensive description of the applicability of the proposed standards to central banks would be useful.

A key point is that the proposals only look at the balance sheet. For central banks the income recognition policy is very important, as income flows into distributions and distributions impact monetary policy. As discussed below, differences in realized and unrealized income matter from a policy perspective. Financial strength and independence based around a strong balance sheet and income streams is a key element in ensuring the central bank's ability to

carry out their policy functions. In particular, they need to ensure that only realised income is available for distribution. Therefore, to meet the needs of central banks, public sector accounting standards items need to include the income effect. This is particularly important as central banks are distinct entities and their financial relationship with government is important in their independence and ability to conduct their functions.

The proposals only cover selected items. A central bank may carry out its monetary policy operations on both the asset and liability side. For example, an injection of liquidity may be made by making an advance, purchase of securities (asset side) or by a reduction in deposits (liability side). Indeed, many transactions affect both sides of the balance sheet. To ensure proper consideration of the accounting and to avoid mismatches, both assets and liabilities need to be considered at the same time.

This point also applies to the IMF accounting where only some of the items are included.

## Specific Items

### Reserve assets

The definition of reserve assets is imprecise and incomplete. In particular, it is necessary to clarify what is meant by foreign currency. We presume it means notes, but what about accounts at other banks, both domestic and non-resident<sup>7</sup>? Central banks hold a portfolio of assets including gold, SDRs and financial instruments in currencies of other countries. The types of assets held and the allocation of the portfolio between them will depend on the circumstances and policies of the central bank. The reserve tranche position arising from IMF membership ranks *pari passu* with SDR Holdings as part of the official reserves.

#### **Preliminary View – Chapter 2**

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?

***The authors agree with the preliminary views expressed in chapter two except for reservations regarding the definition of reserve assets***

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<sup>7</sup> The residence of the counterparty is important. Accounts with domestic financial institutions, denominated in foreign currency do not qualify as 'foreign reserves'

## Currency in circulation

The authors agree with the definition of currency in circulation as applying to the national

### **Preliminary View – Chapter 3-1**

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

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

***The authors believe that the definition of currency in circulation needs to reflect the differentiation that exists in the power to issue notes and coins in some jurisdictions.***

currency as defined. This overcomes issues of those central banks operating in a dollarized economy (e.g. Liberia, Ecuador). However, the paper should not assume that the central bank is the only entity that issues currency within a country.

Although there is an obvious similarity between notes and coins, certainly from the users' perspective, the position from the 'issuers' (to use a simple term even if not legally correct) perspective may differ. Indeed, in many countries notes and coins have different 'issuers'. Notes are typically issued by the central bank, whilst coins are issued by central government, typically the treasury branch of the ministry of finance or an agent thereof. In the US, the Federal Reserve issues bank notes but they bear the signature of the secretary of the treasury.

### **Preliminary View – Chapter 3-2**

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

Do you agree with the IPSASB's Preliminary View – Chapter 3-2?

***The authors agree that the issue of notes create a demand liability for the issuer but believe that, depending on historical and legal circumstance that the option should exist to recognize coins as an expense or as a liability.***

Whilst banknotes are clearly liabilities, whether there is explicit acknowledgement of this on the notes themselves (such as the UK) or not, the position of coins is less clear. In the authors' view, this difference relates to the history of the two types of currency. Banknotes never had any intrinsic value and relied for their acceptance on the status of the issuer and in many cases on specific 'backing' for the notes in the form of gold or other assets. This situation remains in currency board arrangements. There is an expectation that notes will be returned to the issuer and redeemed for equal value, however that may be delivered in a fiat currency environment<sup>8</sup>. Coins on the contrary originally had an intrinsic value in the form of precious metals of which they were made. The issuer, for example the sovereign whose head

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<sup>8</sup> Banknotes are moved between the central bank and commercial banks on a daily basis. The arrangements vary from country to country.

appeared on them, was effectively giving a guarantee of the purity of the metal. There was no expectation or need for the coins ever to return to the 'issuer'.

Although things have changed over time and both notes and coins now have little or no intrinsic value, some of these underlying issues still apply.<sup>9</sup> Coins may not give rise to a legal liability on the 'issuer' and indeed may never be withdrawn from circulation. Issue of these is regarded as a sale. Even if there is a legal liability, the long period coins remain in circulation means that it can be ignored on practical grounds as it is more of a contingent liability. In addition, the value of coins in circulation is normally immaterial in terms of the total money supply.

Notes in contrast have a fairly short life (although newer polymer notes will last longer but not the decades that coins may remain in circulation) and are regularly returned to the central bank. Indeed, there are large flows in out every day as part of regular central bank operations in markets.

The authors are of the view that notes are liabilities but coins are not necessarily so. From the perspective of consistency, it would be advantageous for coins to be treated in the same way, it is not absolutely necessary as it may require amendments to the central bank law or special agreements between the bank and treasury.

The fact that coins and notes may have different issuers has a further accounting impact. Central banks should not show their own banknotes as assets (a claim on yourself is not an asset) but can hold coins if issued by another entity. Conversely the entity issuing of the coins should not hold these as assets, other than as unissued stock, but can recognise notes as an asset as they are a claim on another entity.

A key issue, identified in the paper, is income recognition in relation to the issue of currency in circulation, commonly referred to as seigniorage. In economic publications, seigniorage is often defined as the difference between the face value of the currency and the production cost. This definition originates with coins and is still an appropriate option for coins today. However, for notes it is inappropriate. A simple example illustrates this. A central bank issues a note in return for a claim on a bank. If the central bank recognises the excess of face value over cost as income and pays it over to the Finance Ministry, what happens when the holder of the note comes in a week or so later to ask for his money back? There is no resource to meet the claim. Sweden provides a real-world example of this. There the level of currency in circulation is declining. The existence of a circulating currency liability enables the bank to recognize the withdrawal of currency without needing to recognize expenses against an income that it has likely previously distributed to its stakeholder.

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<sup>9</sup> The value of the metal exceeds the face value of coins in some states and therefore there have been occasions when coins were melted down for their metal content.

Consequently, central banks define seigniorage as the income from the assets backed by the note issue, less the costs associated with the note issue operations, including production, storage, transport and destruction. There may be a specific portfolio of assets assigned as backing the note issue [Bank of England], or more commonly a proportion of the total assets of the central bank is notionally regarded as backing the note circulation and a corresponding share of the total income regarded as seigniorage. The costs incurred in the note issuance is deducted from this income to give the actual seigniorage. Of course, there must be income generating assets matching the note liability for there to be any seigniorage. For some central banks this is a problem.

**Specific Matters for Comment – Chapter 3-1**

(a) When the monetary authority assesses that a present obligation does not exist as a result of the issuance of currency, because of the absence of 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.

***Should the issuer choose to expense coins the appropriate statement is in the statement of financial performance with a note disclosing the nature of any contingency for its return***

***Coins can be considered as a sale but with the probability of return at a later date. It would be conceptually possible to discount the liability to reflect the return date of say 30-40 years. However, the financial effect is likely to be immaterial***

Further issues with respect to note circulation need consideration

- i. Derecognition of the liability for notes that will not be returned to the issuer
- ii. Status of notes in discontinued series that are still in circulation
- iii. Recognition of the costs of production of notes

*Derecognition of the liability for notes that will not be returned*

It is well known amongst central banks that not all notes issued will be returned. This will be for a variety of reasons. Notes are lost, destroyed (e.g. in washing machines) deliberately destroyed, buried for safe keeping and forgotten, included in commemorative or other products. In some countries, old notes will have a value to collectors in excess of their nominal value. Various practices have arisen in different countries as to the treatment of old notes. Some countries have legislation that notes withdrawn from circulation will not be honoured by the issuer after a specific date. Others will always honour their own notes. For countries who do not honour their notes after a period, the value of outstanding notes should be removed from circulation when they cease to be capable of redemption. For countries who always honour notes, a practical regime may be adopted, under which outstanding notes are removed after a period, say 10 years after the notes were withdrawn. For banks reporting under IFRS this latter practice was not acceptable and consequently notes must remain as liabilities indefinitely.

### *Recognition of the costs of notes*

Central banks treat the costs of production in various ways. Many larger central banks expensed all the costs in the year they are incurred, and do not recognise inventories of unissued notes or attempt to spread the cost over the life of the notes. This is largely on grounds of materiality but also because notes typically have a relatively short life.

Smaller central banks commonly recognise unissued notes as inventory items, but still expense notes on issue. The impact on both balance sheet and income statement is more material for such banks, particularly as they commonly buy several years supply at once, rather than being able to purchase as required.

The use of polymer notes changes the situation. The notes are significantly more expensive to produce but also last longer. As the notes will be earning seigniorage (in the form of interest on the matching assets) there is an argument under the accruals concept for spreading the cost of the note over the estimated life of the note.

### Commemorative coins

Many jurisdictions issue commemorative coins, which whilst technically in circulation are never expected to be used as currency. These are commonly treated as outright sales. There should be a specific article in any standard on accounting for currency.

### Monetary Gold

Monetary gold is a central banking concept that derives from the days of the gold standard when central banks backed their national currency with gold holdings. These days it applies as an element of foreign exchange reserves. Its definition differs from London good delivery (LGD) gold, the general concept of internationally traded gold. Monetary gold comes in more forms than LGD. Conversely, all the gold that the central bank holds that is of .995 standard may not be monetary gold. Several central banks, especially in south and central America have museums of gold artefacts from earlier civilizations that are of this purity but which the central banks exclude from monetary gold definitions.

Also, the authors have worked in central banks where the monetary authority was not the holder of the monetary gold that was included in the foreign reserves. Also, in the event of a gold swap is the central bank who owns the gold pledged as collateral still the holder? In the case of unallocated gold, the central bank has a floating claim over a pool of gold holdings that meet a definition that qualifies them as monetary gold. The Federal Reserve does not hold physical gold, only gold certificates.

A definition such as “monetary gold has a minimum purity of 995 parts per 1000 that the monetary authority has the authority to class as part of official reserve assets.” may offer a more encompassing definition of this asset class. The critical aspects are:

- The gold’s purity [not its form], and
- The monetary authority’s ability to class it as a foreign reserve asset



In the consultation document, Para 4.7 states “monetary gold does not meet the IPSAS definition of a financial asset because of its physical nature.” Hence the requirements of IPSAS 29 do not seem to be relevant here. The challenge is to either create a specific asset class for monetary gold or amend IPSAS 29 to include monetary gold. The issue is less critical for the measurement basis but rather the subsequent treatment of the revaluations.

An entity should be able to define the recognition and measurement policy for their monetary gold holdings in a form consistent with the purpose for holding the gold and the accounting for gold held for similar functions.

**Specific Matters for Comment – Chapter 4-2**

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

- i. Market value; or
- ii. Historical cost?

*The authors believe that an entity should have the option to measure monetary gold on the same basis that it employs for the other instruments held for the same functional purpose (foreign reserves management). However, if this would require the reporting of valuations through profit and loss then it would seem to compound the current issues of profit and loss volatility. In such situations, an entity should have the option to adopt cost.*

*From the WGC research, 60 of 69 central banks report gold at market value (with some modifications) while 9 adopted historic cost (with some modifications), but few report gold valuations through profit and loss.*

Some central banks with large holdings of monetary gold apply a haircut to market value. Reasons for this could be conservatism, the prospect of a large gold sale reducing the quoted market value, or the costs of getting the gold to market. Any standard that endorses market value could usefully address the issues of what adjustments to quoted market price are acceptable in terms of transport and refining the gold to LGD standards.

In paragraph 4.3, the best way that gold can meet emergency liquidity needs is through gold swaps. Outright gold sales for liquidity are unlikely as their volume risks distorting prices. Hence the central bank gold agreements. The consultation paper mentions the illiquidity of the gold market for large transactions and should retain this position consistently through the paper. An entity should disclose any limitation on the liquidity of the portfolio through notes to the accounts rather than price discounts.

Review of monetary authorities’ accounting for monetary gold reveal that the main issue is not how to recognize monetary gold, but rather how to treat the unrealized revaluations arising from the application of market value. This treatment of unrealized revaluations is a critical issue for central banks. The authors refer the consultation paper to a World Gold Council consultation paper **Working towards a common accounting framework for gold**, prepared by Kenneth Sullivan [available from the WGC web site].

*Treatment of revaluations*

The consultation paper discusses the issue of the treatment of revaluations in paras 4.35 – 4.40.

As discussed in this paper's introduction, central banks seek to avoid reporting unrealized revaluation gains through profit and loss. Paragraph 4.40 suggests this reluctance is due to a central bank's desire to maintain strong capital. A more important issue is that the reporting of unrealized revaluations as distributable profit conflicts with a central bank's functional objectives. Hence the need for a separate accounting treatment for gold revaluations rests more on policy than capital maintenance considerations. As discussed, this requirement applies to all financial instruments as well as monetary gold.

Under an IFRS framework the authors would argue for the disclosure of unrealized revaluations through the other comprehensive income section (OCI) of the Statement of Comprehensive Income (SOCI) as it represents a movement in balance sheet values. Under IPSAS the authors would argue for the disclosure of unrealized revaluations through the Statement of Changes in Net Assets/Equity, the IPSAS equivalent to SOCI. This addresses the needs for transparency, and disclosure of the source of changes in balance sheet values but removes the values from consideration of distributable profits.

Gold revaluations comprise two elements, movements in the gold price and movements in the currency value between the quoted currency (USD) and reporting currency. How does the consultation paper propose treating these separate elements? It seems implicit that the consultation paper treats monetary gold as an asset quoted in the reporting currency and so sees no need to differentiate between the price and currency elements of any revaluation. The authors agree with this approach as an entity holds any unrealized revaluations to offset future revaluation losses without needing to differentiate between price or currency elements. However, any standard needs to be quite explicit in how it views monetary gold.

The consultation paper is silent on the treatment of unrealized revaluation losses in excess of any unrealized revaluation gains included in reserves. The most frequent practice amongst central banks is to allocate unrealized revaluation losses against revaluation reserves until the reserve is depleted. After this the entity reports any unrealized revaluation losses through profit and loss. This is a conservative approach that while breaching a concept that the profit and loss will exclude unrealized revaluations, ensures that profit absorbs excess revaluation losses before determining any distributions in that year. The alternative to this conservative position is to enable the revaluation reserve to accumulate unrealized losses (debit balances) on the basis that the price movement is cyclical and will eventually reverse. Any IPSAS standard could have a position on this issue that is consistent across all unrealized revaluations. The authors are sceptical about holding temporary debit balances, as it leaves open the definition of temporary, and runs the risk of such debit balances becoming permanent.

Any standard on monetary gold should specify the same treatment of realized gains and losses as it does for other financial instruments. While an argument exists for a central bank to retain realized gains based on maintenance of economic capital concepts, the authors support an approach that recycles realized revaluations through profit and loss. This helps offset previous excess unrealized revaluation losses charged to profit and loss and is consistent with the main thrust of accounting conventions. Arrangements for distribution of dividends should address issues of the maintenance of economic capital.

### *Issues outstanding for the accounting for monetary gold.*

Any revision of the consultation paper into a draft standard could usefully include the follow issues that apply to the accounting for monetary gold

- Determine the cost of sales for monetary gold
- Accounting for swaps, gold deposits, certificates
- Disclosures in financial statements relating to monetary gold
- A paragraph identifying that the standard does not apply to non-monetary gold

### Transactions with the IMF

#### **Preliminary View – Chapter 5-1**

The 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?

***The authors disagree with the definition of IMF Quota Subscription as an asset based on***

- Lack of definition of "member"- this is likely to be different from the reporting entity***
- Failure to recognize the quota's component elements of reserve tranche, a demand foreign exchange asset, and subscription, a contingent right to borrow***

***The authors agree with the definition of SDR Holdings***

***The authors believe the definition of SDR allocations would benefit from a replacement of "and that are related to" with "that arise from"***

Transactions involving the IMF are a particularly difficult and confusing area under contemporary accounting concepts. The authors have a material concern regarding the paper's lack of discussion regarding the meaning of the term "member". This has a material impact on the accounting treatment as definition of member will impact which public entity carries the costs and benefits of the membership's assets and liabilities. In addition, each country must interpret the definition of member in relation to its national laws as various definitions of this concept exist.

The IMF's guidelines for accounting for IMF membership and transactions date back to the 1940s when most central banks were only a branch of the ministry of finance. The use of the term "agent" seems not to have considered the prospect of an independent central bank as an entity separate from the ministry of finance. The emergence of independent central banks raise material principal – agency concerns when accounting for IMF membership.

The IMF and its relevant treaties refer to the member, which is the member country and the IMF undertakes all transactions with the member. However, it is not clear which is the counterpart institution in the member's country, the central bank or the government. Even within the IMF there is difficulty in finding consensus as the legal opinion is that the ministry of finance is the member as they sign all documents, while the IMF finance department

prefers the central bank as member. Generally, both are involved, with some transactions being with the central bank and others with the government. On joining, the member may identify the ministry of finance or the monetary authority as the agent but the monetary authority is always the depository. The circumstances vary from country to country, sometimes due to differences in the law, but as often due to ongoing confusion over the meanings and substance of the terms **member, agent and depository**. The paper could usefully explore these terms within the context of the principal-agent arrangement.

This is not a trivial matter and has resulted in a diverse range of practices amongst central banks regarding their accounting for IMF memberships and transactions. It is not just a matter of who the membership specifies as “agent” [ministry of finance or central bank] as even for countries where the member specifies the central bank as agent there is considerable diversity over which elements of the membership appear on the ministry of finance or central bank’s balance sheets.

An example. If the member issues government securities and lodges them in its depository in the central bank, then how is this a central bank liability? It is only holding these notes as a depository, not as principal. So, if it is not a central bank liability, how can the offsetting for the non-reserve tranche portion of the subscription be a central bank asset? In some situations, the central bank issues the depository securities that could then make it a central bank liability. This is just a simple example of the different situations that arise. A more substantive example of the problem is the situation where any proceeds of an IMF program are split between the ministry of finance and central bank. When presenting its financial statements, a central bank can aid transparency by presenting its foreign reserve assets as a group of foreign currency financial assets. These would include monetary gold, SDR holdings and the reserve tranche as these all qualify as reserve assets under BPM6.<sup>10</sup> However, the subscription portion of the quota does not qualify as a reserve asset, thus reinforcing the concept of the quota as a composite of different items.

The authors suggest that this section would benefit from further consideration of the accounting practices to reflect the evolved situation of central banks, a clearer definition of member and the roles of agent and depository [the IMF requires that the central bank or monetary authority be designated their depository] and the composite nature of the “quota”.

Also, the consultation paper should include all the transactions involving the IMF including, currency valuation adjustments (revaluations), borrowing from both the fund and the related trusts. The discussion omits any discussion of the No.1 and 2 accounts, both of which are integral elements of any subscription transaction. Also, loans to the IMF need to be included.

Under evolved accounting concepts and the emergence of independent central banks these issues concerning which balance sheet, the central bank’s or the government’s, the transactions appear on is complex, and confusing. However, they are material issues as the assignment of assets and liabilities defines on whose balance sheet gains and losses

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<sup>10</sup> Sixth Edition of the IMF’s Balance of Payments and International Investment Position Manual (BPM6)

crystallize. This may compromise a central bank's independence.

#### **Preliminary View – Chapter 5-2**

The IPSASBs view is that:

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

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

***The authors disagree with the preliminary view regarding the recognition of the quota as an asset. Any accounting standard should decompose the "Quota" into its Reserve Tranche and subscription elements. The reserves tranche portion qualifies as a financial asset and should be accounted for as a demand foreign currency deposit***

***The subscription portion is not a financial asset. If it is recognized as an asset it should be recognized as a non-financial asset valued as a foreign currency asset and accounted for in terms of recognition of the contra liability entry.***

***The reserve tranche is a demand foreign currency asset***

***The authors believe that SDR Holdings meet the definitions of a foreign currency demand deposit and should be accounted for as such.***

***The authors believe SDR allocations have similar characteristics as currency in circulation and should be accounted for as a remunerated foreign currency demand liability,***

***Both the SDRs and the allocation should be recognised at the date of allocation. Interest on the SDRs and the allocation is commonly paid net, but properly should be shown gross in the financial statements as the central bank cannot net the instruments on the balance sheet and the asset and liability balances do not usually match each other.***