



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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**Agenda Item
10**

DATE: MARCH 2, 2007
MEMO TO: MEMBERS OF THE IPSASB
FROM: MATTHEW BOHUN
SUBJECT: FINANCIAL INSTRUMENTS

OBJECTIVE OF THIS SESSION

To **approve** the initiation of a project addressing the recognition, measurement, disclosure and presentation of financial instruments.

AGENDA MATERIAL:

Papers

- 10.1 Project initiation document – Financial Instruments
- 10.2 Issues Paper – Financial Instruments

ACTION REQUIRED

The IPSASB is asked to:

- **review** the attached project initiation document and issues paper, **identify** any further issues that need to be included and other amendments; and
- **approve** the project initiation document, and the initiation of a project on financial instruments.

BACKGROUND

In December 2001, the IPSASB issued IPSAS 15, “Financial Instruments: Disclosure and Presentation” which was based on the 1998 version of IAS 32, “Financial Instruments: Disclosure and Presentation”. Since IPSAS 15 was issued, the IASB has updated its disclosure requirements for financial instruments, removing them from IAS 32 and issuing them in a new standard – IFRS 7, “Financial Instruments: Disclosures.” The IASB has not made significant changes to its presentation requirements, which are still located in IAS 32, “Financial Instruments: Presentation”.

To date the IPSASB has not addressed the recognition and measurement of financial instruments. In past discussions the IPSASB has been concerned that the IASB’s financial instruments standards were in a developmental stage, were unduly complex and that they had not received universal approval. The lack of an IPSAS has meant that those applying IPSASs have had to use

either IAS 39, or some other standard, with appropriate modifications to ensure that they are still compliant with other IPSASs, including IPSAS 15.

The IPSASB has not addressed, either in IPSAS 15, or in any other IPSAS, public sector specific financial instrument reporting issues, including the treatment of official reserve assets, monetary gold, special drawing rights and derivatives of these instruments. The IPSASB will need to reexamine the definition of “financial asset” when it addresses the treatment of monetary gold and special drawing rights as these are classified as financial assets that are not a liability or equity instrument of another entity.

IPSASB staff propose that, given the current resources of the IPSASB and the stage of development of other projects, this is an opportune time to initiate a project to develop a comprehensive suite of IPSASs addressing financial instruments.

KEY ISSUES

There are a number of key issues that will need to be addressed. These are presented in detail in the attached issues paper and in summary in the attached project initiation document. These issues include:

- Official reserve assets
- Monetary gold
- Special drawing rights
- Bank notes and coins on issue
- Government bonds on issue
- Fair value measurement
- Perpetual debt instruments
- Financial instruments held for trading
- Hedge accounting
- Derivatives
- Hybrid instruments
- Impairment of financial assets
- Disclosures
- Presentation

Some of these issues have been addressed by the IASB previously and some have not. Some of these issues are specific to the public sector, or are of more importance in the public sector than in the private sector.

Task Force

This project involves issues of considerable complexity that have aroused considerable controversy in the financial reporting community. It is proposed that a task force of five to seven members, chaired by an IPSASB member, will be selected by the IPSASB Chair and Technical Director.

Project Initiation Document

A standard practice within IFAC is for Boards and Committees to circulate project initiation documents (PIDs) to other areas when initiating a project. This enables other areas of IFAC to be aware of each other's projects and draw attention to the need for input from other areas. Attachment 10.1 is the PID for an IPSASB project on financial instruments. This PID will be circulated after the IPSASB agrees to initiate a project. Any comments received will be circulated to the IPSASB.

Issues Paper

Staff have prepared an issues paper outlining many of the issues that have been identified as needing to be addressed by this project. As has been noted, some of these issues are specific to the public sector, and others will need consideration of public sector issues relating to them. The issues paper identifies where staff believe that a divergent treatment from the provisions of the IASB's standards may be warranted. The issues paper also identifies the basis on which staff will recommend departures from a related IAS or IFRS.

Alternative to Initiating a Project

If the IPSASB decides not to initiate a project on financial instruments, IPSAS 15, "Financial Instruments: Disclosure and Presentation" should be withdrawn immediately to prevent any further conflict between IPSAS 15 and IFRS 7, IAS 32 and IAS 39. Staff do not recommend this approach as it does not adequately address the public sector issues raised in the Issues Paper.

ACTION: Staff recommend that the IPSASB approve the PID and initiate a project to revise IPSAS 15 and develop IPSAS based on IAS 39 and IFRS 7, with appropriate requirements and guidance addressing public sector specific issues.

**Matthew Bohun
TECHNICAL MANAGER**



**INTERNATIONAL PUBLIC SECTOR
ACCOUNTING STANDARDS BOARD**

PROJECT BRIEF AND OUTLINE

1. Subject

Financial Instruments: Recognition, Measurement, Presentation and Disclosure.

2. Project Rationale and Objectives

When initiation of a project on financial instruments has been considered previously, there was some opposition in the IPSASB for the following reasons:

- The IASB are constantly changing the IFRSs;
- The IFRSs are unduly complex;
- The IFRSs have not received universal approval, particularly in Europe;
- Public sector entities are free to apply the IFRSs; and
- The IFRSs do not provide application or implementation guidance that is specifically applicable to the public sector.

These are valid issues and represent the major problems and key issues to be addressed by the IPSASB in developing this project.

a) Issue identification

Currently, there is no IPSAS addressing the recognition and measurement of financial instruments, and the IPSAS 15, "Financial Instruments: Presentation and Disclosure" no longer converges with IAS 32, "Financial Instruments: Presentation" and IFRS 7, "Financial Instruments: Disclosure."

Increasing numbers of public sector entities are applying IPSASs when preparing their annual general purpose financial statements. These entities are required to establish accounting policies in relation to the recognition and measurement of financial instruments that are consistent with the IPSASs. When IPSAS 15 was converged with IAS 32, this was not a critical issue as entities were required to apply IPSAS 15, and most would develop recognition and measurement policies based on adopting IAS 39, "Financial Instruments: Recognition and Measurement." Now that there is a divergence from the presentation and, more especially, the disclosures required by the IFRSs and those required by IPSAS 15, it has become a more urgent issue to develop a consistent suite of IPSASs addressing financial instruments.

Financial Instruments are more commonly held and are more material for many public sector entities than many of the items currently addressed in IPSASs, it seems incongruous,

therefore, that the IPSASs specifically and comprehensively address construction contracts, for example, but do not comprehensively address financial instruments. Several significant constituents of the IPSASB, including the UN, have requested that the IPSASB address convergence with IFRSs as a priority, in particular addressing financial instruments.

b) Objectives to be achieved

The objectives of this project are to develop recognition and measurement requirements, and revise presentation and disclosure requirements, for public sector entities applying IPSASs.

c) Link to IFAC/IPSASB Strategic Plans

Link to IFAC Strategic Plan

IFAC's Strategic Plan calls for the global convergence of financial reporting standards. This project links to that plan by further converging IPSASs with IFRSs. The project furthers the public interest by providing public sector entities with independently established financial reporting standards addressing financial instruments, further enhancing the transparency and accountability of entities adopting IPSASs.

Link to IPSASB Strategy

IPSASB's strategic plan establishes IFRS convergence as one of its four priorities. This project will further this priority by converging the existing IPSAS 15, "Financial Instruments: Presentation and Disclosure" with the latest developments in IAS 32, "Financial Instruments: Presentation" and IFRS 7, "Financial Instruments: Disclosure" and by establishing an IPSAS addressing the recognition and measurement of financial instruments that converges with IAS 39, "Financial Instruments: Recognition and Measurement."

3. Outline of the Project

a) Project Scope

The scope of this project is all public sector entities other than Government Business Enterprises (GBEs). The "Preface to International Public Sector Accounting Standards" explains that GBEs apply International Financial Reporting Standards issued by the International Accounting Standards Board.

b) Major Problems and Key Issues that Should be Addressed

There are a number of key public sector financial issues that are not addressed in the IASB's Standards that need to be addressed by an IPSASB project on financial instruments, including:

- (i) Official Reserve Assets – these assets are officially designated as held to meet a country's balance of payments obligations in a time of crisis.
- (ii) Monetary Gold – gold of exceptional purity held by the monetary authority as part of a country's reserve assets. Monetary gold is classified as a financial instrument, although it has no counterparty. The measurement of monetary gold is conceptually different to that of commodity gold. The monetization and demonetization of gold also warrants special attention.

- (iii) Bank Notes and Coins on Issue – are a liability of the monetary authority and of a national government. These are not addressed in the IASB's standards.
- (iv) Special Drawing Rights – international reserve assets created by the IMF and allocated to its members to supplement existing reserves. SDRs are only held by monetary authorities of IMF members and a limited number of authorized international financial institutions. SDRs are a financial asset without a corresponding liability.
- (v) Government Bonds – debt instruments that carry a guarantee of payment by the government. The IPSASB will need to consider whether any specific disclosures are required in relation to government bonds.
- (vi) Fair Value Measurement – this issue is controversial in the private sector and is likely to be so in the public sector. The IPSASB will need to consider how, and the extent to which, fair value measurements are to be used for financial instruments in the public sector.
- (vii) Perpetual Debt Instruments – governments have issued perpetual debt instruments. It is possible that the IASB may require all perpetual debt instruments to be classified as equity. The IPSASB needs to consider the circumstances in which perpetual debt instruments issued by public sector entities will be classified as equity instruments.
- (viii) Financial Instruments Held for Trading – the classification of instruments as held for trading has not always been clear cut, which is one of the reasons why the IASB has the long term objective of measuring all financial instruments at fair value. The IPSASB will need to consider its position on these instruments.
- (ix) Hedge Accounting – the IASB has expressed its concern over the various types of hedge accounting currently allowed. It is of the view that these should be rendered unnecessary if fair value accounting is adopted. The IPSASB will need to consider its position regarding the use of hedge accounting in the public sector.
- (x) Derivatives – are complex and evolving financial instruments that can be difficult to classify and measure. These instruments are increasingly being used in the public sector and the IPSASB will need to consider whether different requirements and guidance are necessary in the public sector.
- (xi) Hybrid Instruments – are used extensively in the private sector. There has been confusion in the private sector about how to appropriately classify and measure the component parts of hybrid instruments – this confusion is also likely to exist in the public sector. The IPSASB will need to develop public sector specific guidance for hybrid instruments.
- (xii) Impairment of Financial Instruments – the IPSASB will need to consider whether it should require entities to assess whether there is any objective evidence of impairment if financial instruments are measured at their fair value. IAS 39 has such a requirement, however, when it developed IPSAS 21, the IPSASB did not require assets carried at fair value to be assessed for impairment. The IPSASB will need to consider whether to extend its impairment principles to financial instruments carried at fair value.

- (xiii) Disclosures – the IPSASB will need to determine whether the disclosures mandated by the IASB in IFRS 7, “Financial Instruments: Disclosures” are appropriate for the public sector, it will also need to determine whether it needs to develop disclosures in relation to monetary gold, special drawing rights and other reserve assets.
- (xiv) Presentation – although the presentation requirements of IAS 32, “Financial Instruments: Presentation” have not been greatly altered since IPSAS 15 was issued, the IPSAS 15 definition of “financial asset” does not include monetary gold or SDRs, nor does IPSAS 15 address the presentation of these assets or other reserve assets.
- (xv) Further IASB developments – the IPSASB will need to monitor developments at the IASB as this project progresses to ensure that the exposure drafts reflect the latest international developments in financial reporting of financial instruments.

4. Describe the Implications for any Specific Persons or Groups

a) Relationship to IASB

This project will strengthen the relationship of IPSASB to the IASB in that there will be a stronger link between the IPSASs and the IFRSs. There is a possibility that IPSASB deliberations on this issue may influence future developments of IASB financial instruments standards.

b) Relationship to other projects in process and planned

This project is part of the IFRS Convergence Project and has implications for the continuous improvements project. There are a number of changes that were made to other IASs/IFRSs as a result of issuing and subsequently amending IAS 32, IAS 39 and IFRS 7 that have not been reflected in the equivalent IPSASs.

A number of IPSASB constituents, in particular those preparing and presenting financial statements in accordance with IPSASs, have been asking IPSASB to address financial instruments in a more comprehensive manner. This project will affect them positively in that at the end of this project they will have a comprehensive set of financial reporting standards that address financial instruments. Many of these constituents are strongly in favor of the IPSASs fully converging with the IFRSs, and this project move the IPSASs closer to the IFRSs.

5. Development Process, Project Timetable and Project Output

a) Development

Consultation Paper

If financial reporting treatments for financial instruments are recommended that are markedly different from those contained in IFRS 7, IAS 32 and IAS 39, the IPSASB may consider it worthwhile to issue a consultation paper first to gauge constituent response to such proposals. For example, if adopting the IASB’s long term goal of measuring all financial instruments at fair value with changes recognized in the statement of financial

performance or a statement of other economic flows is proposed, the IPSASB may want to determine constituent views on that issue before developing exposure drafts.

Development of Exposure Drafts

The initial stage of this project is anticipated to be the development of exposure drafts. The exposure draft shall render IFRS 7, IAS 32 and IAS 39 into IPSASB language – primarily by changing the terminology identified in previous IPSASs and the change from southern British English to US English. The exposure draft shall also adapt the implementation guidance and application guidance for each standard to the public sector, providing public sector specific examples, possibly omitting some of the material relating to the issuance of equity securities, which is of less relevance to the public sector.

The exposure drafts must also address public sector specific issues such as the issuance of bank notes and coins, monetization and demonetization of gold, the issuance, recognition and measurement of special drawing rights in the International Monetary Fund, reserve assets and sovereign guarantees.

The project will develop exposure drafts of proposed IPSASs and final IPSASs. If required a consultation paper can be issued first – as the project develops the need for a consultation paper will be assessed. It may be possible to develop exposure drafts directly. The task force will focus on developing public sector specific application and implementation guidance.

b) Project timetable

Project initiation by IPSASB	March 2007
Development of ED	May 2007 – December 2008
Approval of ED	March 2008
Consideration of Responses	November 2008 – March 2009
Development of IPSAS	April 2008 – December 2010
Approval of IPSAS	March 2011

c) Project output

The outputs of the project will be:

- A revised IPSAS 15, “Financial Instruments: Presentation.”
- A new IPSAS XX, “Financial Instruments: Recognition and Measurement.”
- A new IPSAS XX, “Financial Instruments: Disclosure.”

6. Resources Required

a) Task Force/subcommittee required?

Due to the controversial nature of this subject and the complexity of financial reporting of financial instruments a task force will be established to develop this project. Task force members will, at this time, be required to fund their own participation.

Due to the complexity of financial instruments and the related reporting issues, staff will need the assistance of a task force in developing public sector specific implementation and application guidance. Staff, therefore, recommend that a task force is established to guide this project.

b) Staff

One technical manager will have overall responsibility for this project, with input from the technical director. Other technical managers will provide input as required.

7. Important Sources of Information that Address the Matter being Proposed

IPSAS 15, “Financial Instruments: Presentation and Disclosure”

IAS 32, “Financial Instruments: Presentation”

IAS 39, “Financial Instruments: Recognition and Measurement”

IFRS 7, “Financial Instruments: Disclosures”

IASB Financial Instruments Project:

<http://www.iasb.org/Current+Projects/IASB+Projects/Financial+Instruments/Financial+instruments.htm>

European Union information on International Accounting Standards:

http://ec.europa.eu/internal_market/accounting/ias_en.htm

Government Finance Statistics Manual 2001, International Monetary Fund.

8. Factors that might add to complexity or length

The European Union modified IAS 39, “Financial Instruments: Recognition and Measurement” before ratifying it. Initially, the EU “carved out” the fair value and hedge accounting sections of IAS 39, however, after modifications to IAS 39 by the IASB, the fair value carve out was removed. The hedge accounting carve out remains – the EU has a more liberal approach to hedge accounting than is permitted by IAS 39. The EU’s approach has the potential to cause EU members of IPSASB, or IPSAB’s EU constituents to prefer the EU’s approach rather than full convergence with the IASB, this may lead to extended debate.

The nature of the financial instruments standards will be complex because financial instruments are complex and evolving. Consequently, the IASB considers its financial reporting standards on financial instruments to be evolving. If the IASB makes significant changes to IAS 32, IAS 39 or IFRS 7, or issues further standards, during the course of the project, this may lengthen the project. Major changes are not currently envisaged.

Prepared by Matthew Bohun

Date March 2, 2007

(Technical Manager IPSASB)

The following should be completed after board or committee approval and after revising the project proposal form to reflect any changes by the board or committee.

Approved by _____

Date _____

(Chair IPSASB)

COMMENTS BY TECHNICAL MANAGERS

The comments of Technical Manager from each technical area are required before this Project Proposal is considered by the board or committee proposing to undertake the project.

Technical Manager to the Compliance Advisory Panel

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the DNC

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the SMPC

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the IESBA

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the IAASB

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the PAIB Committee

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the IAESB

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the Transnational Auditors Committee

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Financial Instruments – Issues Paper

Introduction

Governments, particularly national governments, play an important role in the financial markets as regulator, issuer of risk free debt securities, and often as the monopoly operator of financial and or commodity markets. These roles enable the government to be not only the market regulator or operator, but to be a market participant as well.

Financial instruments are used extensively in the public sector for many of the same reasons, and in many of the same ways, that they are used in the private sector. Financial assets are used in the public sector as:

- Official reserve assets
- Operational tools, including accounts receivable
- Investments, including those used to offset unfunded pension fund liabilities; and
- To manage the operational risks a public sector entity faces, such as the price of a commodity, interest rate variations, cash flows or foreign exchange rates.

Financial liabilities in the public sector are used to:

- Finance government activities; and
- Manage operational risks.

Equities are issued by public sector entities in limited circumstances. Equities are issued by a government or other public sector entity when a government business enterprise is partially privatized, or when a public sector entity is owned by two or more public sector entities and is established as a company with share capital.

Financial instruments are complex in nature, and analysis is needed to determine whether the item should be recognized, and, if so, whether an instrument should be classified as an asset, a liability or net assets/equity. Financial instruments are an evolving item, with new instruments continually being developed, and modifications being made to existing instrument types. These instruments are developed for a variety of reasons, including providing more innovative methods of managing the risks inherent in the modern economic environment. These instruments may also be developed with a view to assisting both private and public sector entities achieve desired financial reporting or taxation outcomes.

Derivative financial instruments, the value of which is dependant upon the value of another phenomenon, such as interest rates, exchange rates or commodity prices, are probably the most complex class of financial instrument. New derivative financial instruments are being developed continually, and each new instrument has different terms and conditions, adding layers of complexity. Classification of these instruments can be difficult, and valuation of instruments that are not traded on an active market is also difficult.

Current Pronouncements on Financial Instruments

Current Position of the IASB

The International Accounting Standards Board has issued three Standards specifically addressing financial instruments:

- IFRS 7, “Financial Instruments: Disclosures” (Issued August 2005)
- IAS 32, “Financial Instruments: Presentation” (Amended August 2005)
- IAS 39, “Financial Instruments: Recognition and Measurement” (Amended August 2005)

IAS 32 was initially approved in 1995 as “Financial Instruments: Disclosure and Presentation” and has been revised periodically ever since, most recently in 2005 when the disclosure requirements were removed and new disclosures established by IFRS 7. IPSAS 15 is based on the 1998 revision of IAS 32. IAS 39 was initially approved in 1998 and has also been revised periodically.

The IASB, as part of the IASB-FASB convergence project, has ongoing long-term project addressing financial reporting requirements for financial instruments. The IASB states its long term objectives in a document published on its website. Its long term objectives are:

1. To require that all financial instruments be measured at fair value with realized and unrealized gains and losses recognized in the period in which they occur.
2. To simplify or eliminate the need for special hedge accounting requirements.
3. To develop a new standard for the derecognition of financial instruments.

The IASB’s financial instruments project is anticipated to take a number of years to complete, although parts of the project will be completed sooner. IAS 32, for example, will be amended within two years to address “puttable instruments.”

The IASB has publicly stated its reservations about its current approach to developing IFRSs for financial instruments. The IASB is of the view that providing additional requirements and guidance to satisfy particular users adds complexity to the standards. The IASB’s long term goals reflect its disquiet with the current approach, it believes that the long term goals will simplify the financial reporting of financial instruments, if they can be implemented.

IPSAS 15, “Financial Instruments: Disclosure and Presentation”

Currently there is an IPSAS that addresses the disclosure and presentation of information about financial instruments: IPSAS 15, “Financial Instruments: Disclosure and Presentation.” IPSAS 15 was developed from IAS 32. However, the provisions of IAS 32 have been further developed, and the disclosure requirements of IPSAS 15 are no longer harmonized with those of IFRS 7, “Financial Instruments: Disclosures.” The presentation requirements of IPSAS 15 are largely in harmony with those in IAS 32, “Financial Instruments: Presentation.” There is no IPSAS that specifically addresses the recognition and measurement of financial instruments. IPSAS 15 is deficient in a number of respects:

its disclosure requirements do not converge with IFRS 7, it does not address the recognition and measurement of financial instruments, and, most importantly, it does not address the financial reporting of public sector specific financial instruments.

Current practice

Developing financial reporting requirements addressing financial instruments has proved controversial for the International Accounting Standards Board. In particular, the 2003 edition of IAS 39, “Financial Instruments: Recognition and Measurement” was only accepted by the European Union after modifications had been made to fair value measurement, and the EU continues to adopt a more liberal approach to hedge accounting than is permitted by IAS 39. In particular the EU did not agree with using fair value to measure an entity’s own liabilities. The EU also did not agree with restricting hedge accounting to cash flow hedging, fair value hedging and hedging of a net investment in a foreign operation. The EU is of the view that the provisions of IAS 39 would not allow European banks to undertake a portfolio hedge of their core deposits. Consequently, the EU “carved out” the fair value and hedge accounting provisions of IAS 39.

In terms of the public sector, IPSASB constituents, including the OECD, EC and UN have reported that in the absence of an IPSAS addressing the recognition and measurement of financial instruments, entities are applying IAS 39 when preparing their financial statements. This may be satisfactory in the short to medium term, however, as IAS 32 and IFRS 7 diverge from IPSAS 15, problems are likely to arise for public sector reporting entities.

Major issues to be addressed in Project

Official Reserve Assets

National governments normally hold some financial assets as “official reserve assets” to be utilized to meet the country’s balance of payments obligations in a time of crisis. These assets are normally held by the country’s monetary authority and consist of monetary gold, special drawing rights in the IMF and foreign exchange reserves – typically in the form of currency or government bonds issued by a government with a reserve currency. The reserve currencies are typically considered to be the European Euro, Japanese Yen, Swiss Franc, United Kingdom Pound Sterling and United States Dollar.

Financial reporting of official reserve assets is not a requirement under IFRS 7, IAS 32 and IAS 39. In addressing financial instruments for the public sector it may be necessary to address the disclosure of a national government reserve assets in the financial statements of the monetary authority and the consolidated financial statements of the national government. The nature of any such disclosures would be considered and specifically identified.

Monetary Gold

Monetary gold is defined in the statistical bases of financial reporting as “Gold coins, ingots and bars with a purity of at least 995/1000 that are (1) owned by units that

undertake monetary authority functions and (2) are a component of the nation's official reserve assets." Non-monetary gold is gold that is not monetary gold and is classified as a commodity and recognized under IPSAS 12, "Inventories". Certain items made of gold may be classified as plant or equipment and recognized under the provisions of IPSAS 17, "Property, Plant and Equipment", for example, a collection of gold coins controlled by a museum may be recognized as plant.

Monetary gold is an asset that is unique to the public sector, and is only held by the monetary authority of a national government. Monetary gold is classified in the statistical bases of financial reporting as a financial asset for which there is no corresponding liability of a counterpart. In the statistical bases of financial reporting it is valued at the current price established in organized markets or in bilateral arrangements between monetary authorities.¹

Gold is monetized when it is acquired and classified as such. Gold is demonetized when it is reclassified as a commodity. In practice, few countries have monetized gold in recent decades, as most countries use other financial assets to build up their official reserve assets. Consequently, monetary gold is often recognized at a value that does not reflect the value of gold in the commodities market. For example, the United States Federal Reserve currently measures monetary gold at USD42.2222 per troy ounce whereas the commodity price on February 22, 2007 was USD676.40 per troy ounce. Monetary authorities in some countries periodically reclassify monetary gold as a commodity and sell it in the commodities market.

Neither the IFRSs nor the IPSASs currently address the recognition, measurement, disclosure or presentation of monetary gold. Monetary gold would not meet the current definition of a financial asset. Guidance on the treatment of monetary gold, which is considered by national governments to be material by nature (although rarely by amount), would need to be considered.

There are several alternatives to the treatment of monetary gold. Firstly, the IPSASB could conclude that monetary gold is not different to other gold, and that it should be recognized, measured, disclosed and presented in accordance with IPSAS 12 or 17. This would result in a major conceptual divergence between the statistical bases of financial reporting and the statistical bases of financial reporting. Measuring monetary gold in accordance with IPSAS 12 would result in the gold being measured at its cost of acquisition.

Secondly, the IPSASB could include monetary gold within the definition of "financial asset" and establish requirements for its recognition, measurement, disclosure and presentation of these assets that converge with the statistical treatment of this item. The measurement of monetary gold is determined by organized markets (the participants in this market are the monetary authorities) or by bilateral arrangements. As noted above, the lack of recent transactions in monetary gold may result in a relatively low measurement value for this monetary gold, when compared to non-monetary gold.

¹ IMF, *Government Finance Statistics Manual 2001*, Washington, USA, paragraph 7.93.

Thirdly, the IPSASB could include monetary gold within the definition of “financial asset” and establish requirements for its recognition, measurement, disclosure and presentation of these assets that converge with IFRS 7, IAS 32 and IAS 39. This would require entities to measure monetary gold at fair value through the profit and loss, unless specific provision is made to require some other measurement. This option would raise the question as to what is the fair value of monetary gold. The market in monetary gold is not active, so fair value cannot be measured by reference to market prices. Therefore, the entity would need to establish a valuation technique. This may result in an estimate of the price that would be established in a bilateral agreement between monetary authorities. This treatment would be convergent with the IASB’s Standards, but divergent from the statistical bases of reporting, although the amount recognized in respect of monetary gold may not be materially different.

The IPSASs will also need to develop requirements and guidance for the disclosure and presentation of both balances of monetary gold and monetization and demonetization of gold, including whether the reclassification of monetary gold as commodity gold that results in a gain, should be recognized in the statement of financial performance in the period in which the reclassification occurs, or whether it should be recognized as a revaluation increment in the statement of changes in net/assets equity.

Bank Notes and Coins on Issue

Monetary authorities of national governments issue bank notes and coins on a regular basis. There are also private sector banks in some countries that issue bank notes, however these banks are normally required to deposit an amount with the monetary authority equal to the amount of their notes on issue. The IASB has not considered the financial reporting treatment of issuing bank notes.

In the statistical bases of financial reporting currency is treated as a liability of the unit that issued the currency. When new currency is put into circulation, a transaction is recorded that increases the issuer’s liability for currency. Usually the counterpart to the increase in liabilities is an increase in the issuer’s financial assets, most likely deposits.

The IPSASs on financial instruments need to address the issue of currency as a liability of the monetary authority and its controlling government. The major issue is presentation and disclosure, as recognition and measurement are not a significant issue.

The IPSASs will need to ensure that they are convergent with both IFRSs and statistical bases of financial reporting, and clearly distinguish between currency as a financial asset and currency as a financial liability.

Special Drawing Rights

Special Drawing Rights (SDRs) are international reserve assets created by the International Monetary Fund (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 IMF members to whom they have been allocated do not have an unconditional liability to repay their SDR

allocations. An SDR represents an unconditional right to obtain foreign exchange or other reserve assets from other IMF members. They can be sold, loaned or used to settle financial obligations. The value of the SDR is determined by the IMF as a weighted average of selected major currencies. Both the currencies and the weights are revised from time to time.¹

The IASB has not considered the financial reporting treatment of SDRs because these financial assets are not held by private sector companies. The current definition of financial asset would not include SDRs within its scope, because there is no equivalent financial liability or equity instrument of another entity. This is a serious deficiency in public sector financial reporting standards.

In developing the appropriate treatment of SDRs the IPSASB will need to ensure that the IPSAS converges with both the statistical treatment and the IAS/IFRS treatment to the extent possible. SDRs need to be included within the definition of “financial asset”. These assets would be recognized and measured according to the principles established in IAS 39. However, the IPSAS should note that the fair value of SDRs is established by the market controlled by the IMF. The value of SDRs is quoted daily in the financial press.

Government Bonds

Government bonds are debt instruments that carry a guarantee of payment by the government that issues them. Typically the bonds of a credit worthy national government establish the “risk free” rate of return in the domestic bond market. These bonds are uniquely issued by public sector entities; however, they are, in principle, no different to any other liability of a public sector entity.

Consideration of any specific disclosures in respect of government bonds will be required.

Fair Value Measurement

The IASB has an ongoing project re-examining the requirements and guidance in relation to fair value measurements. The IASB has the long term objective of requiring fair value measurement of all financial instruments, although it does not expect to be in a position to require this for several years. Fair value measurement has been controversial in Europe because some European banks argue that it is not appropriate for an entity to value debt instruments it has issued at fair value. The IASB was of the view that IAS 39 did not require an entity to measure its own debt instruments at fair value, however it amended IAS 39 to clarify that entities were not so required.

The progress of the IASB’s fair value measurement project will be monitored as the IPSAS project progresses to ensure that any amendments made to the IASB’s standards are reflected. The consequences of any exposure drafts issued by the IASB during the project’s duration will also be considered.

¹ IMF, *Government Finance Statistics Manual 2001*, Washington, USA, paragraphs 7.95 – 7.96.

Perpetual Debt Instruments

The IASB, as part of its convergence project with the Financial Accounting Standards Board (FASB) of the USA, has issued “Milestone Draft – Proposed Classification for Single-Component Financial Instruments and Certain Other Instruments”. This paper proposes, among other things, that perpetual debt instruments be classified as equity in all circumstances. This may have an impact on IASB – IPSAS convergence as there are examples of national governments issuing perpetual debt instruments. For example, the British and Canadian governments issued perpetual 3% bonds in 1936. These types of instruments will be considered and the circumstances in the public sector in which such instruments would be considered equity will be addressed.

There are two alternatives with regard to perpetual debt instruments: classification as liabilities, or as equity instruments. If the IASB adopts the approach proposed in the Milestone Draft (classification as equity) a divergent treatment could result if the IPSASB adopts the alternate classification as liability.

Financial Instruments Held for Trading

Financial instruments (whether assets or liabilities) that are held for trading are measured at fair value (gross of any transaction costs) under IAS 39, with any changes in fair value recognized in the statement of financial performance in the period in which they occur. The classification of financial instruments as held for trading has not always been clear-cut, which is one of the reasons why the IASB has the long term objective of moving all financial instruments to fair value measurement.

There may be merit in adopting the IASB’s long term goals in the short term – or at least to proposing a question in the exposure drafts suggesting that all financial instruments be measured at fair value, with changes recognized in the statement of financial performance, or in a separate statement of other economic flows, as is the case with the statistical bases of financial reporting.

Hedge accounting

The IASs/IFRS currently establish requirements for three types of hedge accounting: fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation. The IASB’s long term goal is for hedge accounting to be rendered unnecessary by the adoption of fair value measurement of all financial instruments, which would mean that the only form of hedge accounting that would be necessary would be commodity hedging.

Consideration of hedge accounting would be undertaken including an assessment of whether it is necessary in an IPSAS on financial instruments. It is possible that comprehensive disclosures of risk management policies would achieve a more transparent approach. Further, if the IPSASB were to decide to adopt fair value measurement for financial instruments in the short term, it would also be appropriate to restrict the use of hedge accounting in the short term.

Derivatives

“Derivative” is a name given to a broad category of financial instrument. Derivatives derive their value from the value of another instrument. For example, the value of a call option on a company’s share is a function of the value of the company’s share, the strike price of the option, and the time until the strike date. Derivatives are used extensively for a variety of purposes. Derivatives will be classified as financial assets, financial liabilities or (rarely in the public sector) equities. IAS 39 provides application guidance on the treatment of derivatives.

Derivatives are controversial because a small outlay has the potential to have a significant impact on an entity’s financial position and performance. The fair value of derivatives can be measured by reference to market price if they are traded on an organized securities exchange, or using a valuation technique if they are not.

Derivatives are used in the same way in the public sector as in the private sector, and there is unlikely to be any necessity for different financial reporting treatment. However, there may be a need for some guidance in relation to a particular type of derivative. Gold swaps are a derivative financial instrument. Where the gold referenced is monetary gold, guidance will be needed to ensure that the treatment of derivatives related to monetary gold is harmonized with the financial reporting treatment required in the statistical bases of accounting and the financial reporting treatment developed for monetary gold in the IPSASs.

Hybrid Instruments

Hybrid instruments are financial instruments that combine features of more than one type of instrument. For example, convertible bonds are generally considered to embody two securities, a bond and an option to purchase shares in the issuer. The IFRSs require the components of a hybrid instrument to be distinguished and accounted for separately. There has been some confusion among private sector entities about how to account for these instruments and this confusion is likely to occur in the public sector as well.

The main issue relating to hybrid instruments for the task force to address is to ensure that the application and implementation guidance provided is clear and oriented toward the public sector preparer.

Impairment of Financial Assets

IAS 39 requires entities to assess at balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. If such evidence exists a loss is recognized. Consistent with the approach taken in IPSAS 21, “Impairment of Non-Cash Generating Assets”, the IPSASB may decide that assets carried at fair value should not be tested for impairment. This would result in a divergence from the IAS, but would be consistent with the approach taken in the IPSASs.

Disclosures

IFRS 7, “Financial Instruments: Disclosures” details the disclosure requirements mandated by the IASB. These disclosures may cause some concern in the public sector if

they are perceived to be too technical or detailed. Apart from monetary gold and SDRs, the nature of financial instruments in the public sector is not different to those in the private sector. Therefore, the disclosures required in the two sectors should be the same. The exception to this will be any additional disclosures to be mandated in respect of monetary gold, SDRs and other reserve assets.

Presentation

The IASB has not made any substantive changes to the presentation requirements in IAS 32 since IPSAS 15 was issued. When the IPSASB issued IPSAS 15 it did not consider the different nature of monetary gold and SDRs as financial assets without a counterparty. Changes therefore need to be made to the definition of “financial asset” in IPSAS 15 to encompass monetary gold and SDRs. Another issue to be considered is whether official reserve assets should be presented separately from other assets in a national government’s consolidated financial statements and a monetary authority’s financial statements. Feedback from constituents on their experiences in implementing IPSAS 15 may be valuable in this area.

Further IASB Developments

The IASB has several current projects underway to further develop the IFRSs on financial instruments. Some of these projects may be finalized within the time frame anticipated for completing the IPSASB’s initial project on financial instruments. Other projects will not be completed for many years, if ever. The reality is that financial instruments are developing constantly, which means that the financial reporting standards setters must constantly monitor these developments to ensure that financial reporting standards adequately capture the reality of the situation facing reporting entities.

The fact that the IASB’s projects will be running concurrently with the IPSASB’s project creates challenges but these are manageable. The number of issues that need to be considered from a public sector perspective highlights the importance of initiating a project on financial instruments.

Should the IPSASB initiate a project on Financial Instruments?

At the most recent IPSASB meeting, observers noted that it is advantageous, when arguing that entities should apply IPSASs, to have a comprehensive suite of relevant IPSASs. The *Handbook of International Public Sector Accounting Pronouncements* should, ideally, contain all the financial reporting requirements an entity needs. Currently this is not the case, as entities need also to refer to the IFRSs or other relevant national guidance to determine the appropriate financial reporting treatment of some items, including financial instruments.

IFAC and the IPSASB pursue a policy of international convergence of financial reporting standards. Developing IPSASs that address financial instruments, based on IFRS 7, IAS 32 and IAS 39 will further this policy. As with any IPSAS the IPSASB develops, public sector specific issues will be paramount when considering if or how to vary from the provisions of the IASB Standard. Variations from IASB Standards are discussed further below.

One of the key issues to be addressed in IPSASs addressing financial instruments is the development of public sector specific implementation and application guidance. The guidance contained in IFRS 7, IAS 32 and IAS 39 is focused on the private sector entities. In respect of financial assets and financial liabilities, this guidance may only need adaptation for the public sector. Less emphasis on the issuing of equity securities is warranted in respect of the IPSASs, however, guidance should still be provided for the limited circumstances in which public sector entities issue equity securities.

Some will argue that there is no need for the IPSASB to devote time and resources to this project, rather it should allow the hierarchy of guidance established in IPSAS 1, “Presentation of Financial Statements” to direct financial statement preparers to IFRS 7, IAS 32 and IAS 39. This argument draws on the fact that entities currently used IAS 39 for the recognition and measurement of financial instruments. Adopting this approach could have a number of consequences as follows:

- IPSAS 15 is no longer harmonized with IAS 32 and IFRS 7. If constituents are to be directed to the hierarchy, IPSAS 15 must be withdrawn, or amended to remove the disclosure requirements, and adjust the presentation requirements to ensure they are fully harmonized with IAS 32.
- The IPSASB may be accused of not being responsive to a specific request from constituents to address this issue. Not providing public sector specific guidance addressing financial instruments may be seen as a shortcoming.
- The current definition of “financial asset” in IPSAS 15 and IAS 32 does not encompass monetary gold or special drawing rights, two public sector specific financial assets. Exclusion of these assets is a significant gap in the Standards that should be rectified.
- Withdrawing an IPSAS, or major provisions of an IPSAS, may be perceived negatively in the financial reporting community, and could drive some jurisdictions towards adoption of the IFRS.

IPSASB’s constituents have asked the IPSASB to develop IPSASs addressing the major areas of financial reporting, and in particular financial reporting of financial instruments.

Given the profile of financial instruments and their prominence in the public sector it is recommended that the IPSASB initiate a project to converge IPSAS 15 with IFRS 7 and IAS 32, develop an IPSAS based on IAS 39, ensuring that each of these converges where possible with the statistical bases of reporting. The IPSASs should also address public sector specific financial instruments, and provide implementation and application guidance tailored to the public sector.

International Convergence

In pursuing its standards setting program, the IPSASB has consistently aimed for international convergence of financial reporting requirements, which is consistent with

the policy of the International Federation of Accountants and with the policies of IPSASB's major constituents and stakeholders.

In practice convergence has been interpreted by the IPSASB as avoiding unnecessary differences between IPSASs, IFRSs and statistical bases for reporting, including the International Monetary Funds *Government Finance Statistics Manual 2001*, the United Nations (and others) *System of National Accounts 1993*, Eurostat's *European System of Accounts 1995*, and Eurostat's *ESA 95 Manual on Government Deficit and Debt*.

The IPSASB takes very seriously any variation from an IAS or IFRS. In developing IPSASs on financial instruments the IPSASB should only vary from the provisions of IFRS 7, IAS 32 and IAS 39 if:

- A particular matter is not addressed by these standards and additional requirements or guidance is necessary.
- The IASB's standards provide two or more possible treatments, and the IPSASB considers that some of these do not further the objectives of public sector financial reporting.
- The IASB has prescribed a treatment, which is appropriate in the for-profit sector, but is inappropriate for the public sector because it does not further the objectives of public sector financial reporting.
- The IPSASB considers that, in order to achieve the objectives of public sector financial reporting, more stringent requirements are necessary than those prescribed in the IASB's standards.
- The IPSASB considers that the IASB has prescribed a particular treatment to address circumstances in the for-profit sector that do not occur in the public sector.
- A conflict exists between the treatment prescribed in the IASs/IFRSs and the statistical bases of financial reporting and the IPSASB considers that the objectives of public sector financial reporting will be better served by adopting the treatment prescribed by the statistical bases of financial reporting.

In all circumstances, where the IPSASB adopts a different treatment to that prescribed in the IASs/IFRSs the reasons for such a change will be outlined in the Basis for Conclusions accompanying the IPSAS and noted in the Comparison with the IAS/IFRS.