Response to Exposure Draft 62 “Financial Instruments” – August 2017, ICGFM

Michael Parry, Chair of the Ad Hoc Committee on International Accounting Standards

Overview

It is not as yet clear how ED62 will be reflected in accounting standards. The documentation includes both a standalone ED62 and also proposed amendments to ED29. This needs to be clarified.

This is a very complex set of proposals. ED62 alone is 410 pages, with additional documentation amounting a further 330 pages. The documents themselves are also very complex, with the use of terminology unfamiliar to most government accountants, and multiple cross references to other standards. Only a limited number of specialists in some governments will need to understand the full complexity of the proposed standards and the implications for financial reporting. But all governments will need to be able to apply the basic principles of reporting on lending to or by governments, and equity investments held by governments.

Therefore, our first **recommendation** is for a structure to any resulting standard, or standards, that is accessible to government financial managers who neither have, nor require, specialist knowledge of the more arcane financial products and situations. **This is very important if the standard is to be properly implemented by many smaller or poorer countries without access to specialist expertise.** In particular the excellent summary and diagrams in the “At a Glance” publication should be incorporated within the Standard.

Specific Matters for Comment

There are just three specific matters for comment as summarised in the table below, together with our response.

Comment request	**ICGFM Response**
Specific Matter for Comment 1: Consistent with the relief provided in IFRS 9, the IPSASB has agreed in [draft] IPSAS [X] (ED 62) to allow an option for entities to continue to apply the IPSAS 29 hedging requirements. Do you agree with the IPSASB’s proposal?	Agreed. This seems sensible There should be provisions for additional disclosure in the notes to the financial reports on conditions relating to risk hedging, peculiarities of repayment on financial liabilities, the acquisition and maintenance of financial assets.
Specific Matter for Comment 2: The IPSASB recognizes that transition to the new standard [draft] IPSAS [X] (ED 62) may present implementation challenges as a result of the number of significant changes proposed. Therefore, the IPSASB intends to provide a 3 year implementation period until [draft] IPSAS [X] (ED 62) is effective (early adoption will be permitted). Do you agree with the proposed 3-year implementation period before [draft] IPSAS [X] (ED 62) becomes mandatory? Please explain.	Agreed As above, a sensible provision in view of the changes

Comment request	ICGFM Response
Specific Matter for Comment 3: Do you agree with the proposed transition requirements in paragraphs, consistent with those provided in IFRS 9? If not, what specific changes do you recommend and why?	Agreed The illustrative examples provided are useful for interpreting ED62. We would suggest these examples should be expanded to include some of the situations and issues faced by members of the ICGFM, as indicated below.

Comments on the proposals

As indicated, most governments do not invest in, or issue, financial derivatives, and there is limited hedging of currency transactions. However, where such situations do occur they can be of national significance. We therefore **support** an approach based on IFRS9 to ensure consistency with commercial practice.

Definition of cash

ED 62 contains no definition of cash and cash equivalents, yet these are the most pervasive of all financial instruments. Cash and cash equivalents are defined in IPSAS 2, para 8. We **recommend** the definition of cash and cash equivalents be repeated in any Standard that results from ED62.

Classification of financial instruments

We support the broad classification of financial instruments between financial assets, financial liabilities and equity.

The classification structure in Paragraphs 39-56 is on the valuation basis. This is not necessarily the most informative presentation for financial reporting. The IMF Government Finance Statistics (GFS) Manual requires classification based on the maturity and source of the financial instrument. We **recommend** that for General Purpose Financial Reports the GFS classification structure is adopted.

Practical problems identified by ICGFM members

The practical problems identified by ICGFM members primarily relate to loans between public sector institutions, e.g.

- Loans by multilateral or bilateral donor organisations, either directly to governments and then on lent to public sector entities, or directly to public sector entities, with various covenants attached. Problems relate to valuing the on lent loan asset when some of the covenants are breached but the loan is not called in. Also, where the loan is directly to the public sector body, impact of the above events on the valuation of other loans to that entity.
- Lending to or by state-owned banks by public corporations on preferential terms (e.g. below market interest rates, repayment at the end of the contract period, informal but regular loan extension, very large lending). The fair value of such lending may be below the nominal value of the loan, but there is often resistance to provisioning against loans to other public sector entities.
- The risk of default by public sector borrowers is real, yet is difficult to assess and quantify. Often political considerations make it very difficult to write off or provide against loans by other public sector entities.

In all of the above situations clear guidance and examples in the IPSAS would support appropriate valuations.

Valuation of financial instruments

As a matter of principle, the value of any financial instruments is the discounted expected future cash flows to be generated or incurred from such financial instrument. Any other measure is a surrogate for the present value of such future cash flows.

Where available, market values provide the best indicator of the above present value of future cash flows, since such values are generated by multiple investor estimates. This will normally be what is referred to as "fair value" and hence the approach is **supported**. For governments, the distinction between fair value through surplus/deficit or through net assets/equity is of limited significance, but we accept it is necessary to keep the distinction for consistency with IFRS 9. We also **support** the amortised cost basis in the limited circumstances described.

However, we **recommend**:

1. The section on valuation should start with a statement of basic principles
2. The clarity of this section be improved by concluding with a simple set of rules (without cross references).

Impairment

We **support** the revised impairment rules which address a criticism of the existing rules particularly for commercial entities.

Response to Exposure Draft 63 "Social Benefits" - October 2017, ICGFM

Michael Parry, Chair of the Ad Hoc Committee on International Accounting Standards

Overview

The Exposure Draft 63 on Social Benefits raises two fundamental issues:

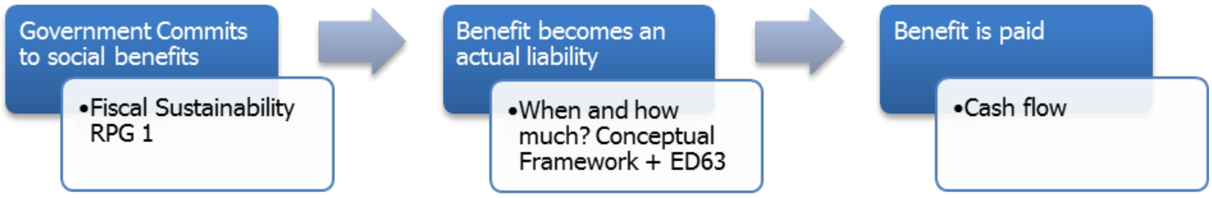
1. The recognition as liabilities commitments made by a government to specific groups of citizens – even though there is no contractual obligation (other than a social contract) requiring future governments to honour such commitments
2. The inter-generational impact of such commitments, e.g. the cost of a state pension payable to all citizens.

Governments across the world commit to certain social benefits, e.g.:

1. Health care benefits
2. Unemployment benefits
3. State pension benefits.

There is a flow from the commitment through liability to the actual payment of social benefits as illustrated in Figure 1 below.

Figure 1: The flow of social benefit obligations



In most countries social benefit commitments made by a current government are honoured by subsequent governments, but such commitments do not amount to legally binding contractual obligations. There are numerous examples where the terms of the social benefit obligation have been retrospectively changed, e.g. raising the age for state pension, reducing the amounts to be paid.

These issues are addressed in the IPSAS Conceptual Framework. This identifies when non-legally binding obligations become liabilities in Para 5.24 as follows:

1. *The entity has indicated to other parties by an established pattern of past practice, published policies, or a sufficiently specific current statement that it will accept certain responsibilities;*
2. *As a result of such an indication, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities; and*
3. *The entity has little or no realistic alternative to avoid settling the obligation arising from those responsibilities.*

The first two conditions are normally part of governments making social benefit commitments. The issue of recognition as a liability is when condition (3) above is met. At some stage social benefits do meet condition (3) and hence become liabilities.

The ICGFM supports the principle of recognising social benefits as liabilities when the three conditions specified in the Conceptual Framework are met

Specific matters for comment

Matter for comment	Response
Specific Matter for Comment 1: Do you agree with the scope of this Exposure Draft, and specifically the exclusion of universally accessible services for the reasons given in paragraph BC21(c)? If not, what changes to the scope would you make?	We agree with the scope
Specific Matter for Comment 2: Do you agree with the definitions of social benefits, social risks and universally accessible services that are included in this Exposure Draft? If not, what changes to the definitions would you make?	There is no actual definition of social benefits in the ED. Para 6 says to whom social benefits are provided but not what they are and Para 5 and AG 1 – 7 what they are not, but nowhere does the ED actually define social benefits As indicated in our comments on the Discussion Paper, we consider the GFS definition should be used: "6.96 Social benefits are current transfers receivable by households intended to provide for the needs that arise from social risks—for example, sickness, unemployment, retirement, housing, education, or family circumstances." We also consider that the two categories of social benefit in GFS should be recognised in the proposed Standard: 1. Pensions and other retirement benefits 2. Non-pension social benefits Social risks are defined in GFS as "Social risks are events or circumstances that may adversely affect the welfare of the households concerned either by imposing additional demands on their resources or by reducing their income". We can see no good reason for using a different definition. One member of our committee considered it important that that social risks are defined by law and the source of social benefits (i.e. the entity that makes the payment) should be specified
Specific Matter for Comment 3: Do you agree that, with respect to the insurance approach: (a) It should be optional; (b) The criteria for determining whether the insurance approach may be applied are appropriate;	(a) and (b) Our comments on the Discussion Paper identified four possible combinations and recommended recognition and measurement approaches as follows: 1. Pensions and other retirement benefits a. Funded – in accordance with IPSAS 25 b. Unfunded – Obligating event approach as described in the ED 2. Non-pension social benefits a. Funded – Insurance approach as described in the ED b. Unfunded – obligating event approach

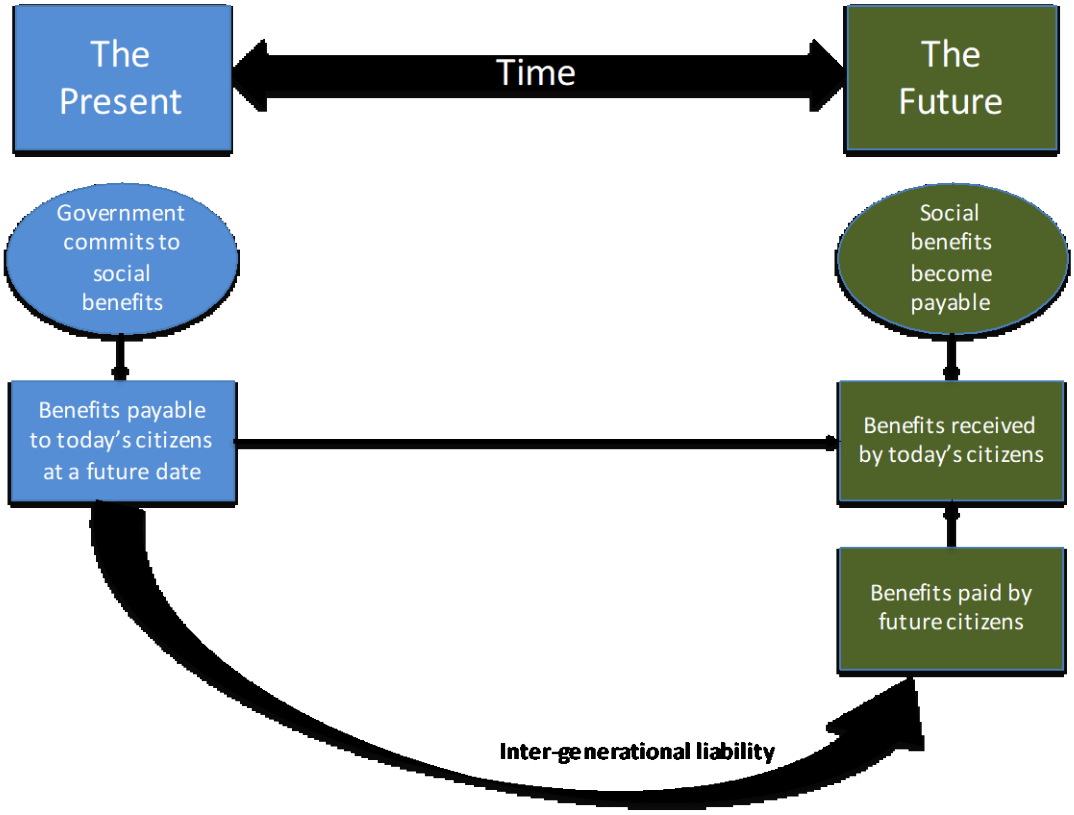
Matter for comment	Response
(c) Directing preparers to follow the relevant international or national accounting standard dealing with insurance contracts (IFRS 17, Insurance Contracts and national standards that have adopted substantially the same principles as IFRS 17) is appropriate; and	(c) Agreed
(d) The additional disclosures required by paragraph 12 of this Exposure Draft are appropriate? If not, how do you think the insurance approach should be applied?	(d) Agreed
Specific Matter for Comment 4: Do you agree that, under the obligating event approach, the past event that gives rise to a liability for a social benefit scheme is the satisfaction by the beneficiary of all eligibility criteria for the next benefit, which includes being alive (whether this is explicitly stated or implicit in the scheme provisions)? If not, what past event should give rise to a liability for a social benefit?	Agreed
Specific Matter for Comment 5: Regarding the disclosure requirements for the obligating event approach, do you agree that: (a) The disclosures about the characteristics of an entity's social benefit schemes (paragraph 31) are appropriate;	(a) Agreed
(b) The disclosures of the amounts in the financial statements (paragraphs 32–33) are appropriate; and	(b) Agreed
(c) For the future cash flows related to from an entity's social benefit schemes (see paragraph 34):	(c) Agreed
(i) It is appropriate to disclose the projected future cash flows; and	(i) Agreed
(ii) Five years is the appropriate period over which to disclose those future cash flows. If not, what disclosure requirements should be included?	(ii) The time period should be at least 5 years

Matter for comment	Response
Specific Matter for Comment 6: Do you think the IPSASB should undertake further work on reporting on long-term fiscal sustainability, and if so, how? If you think the IPSASB should undertake further work on reporting on long-term fiscal sustainability, what additional new developments or perspectives, if any, have emerged in your environment which you believe would be relevant to the IPSASB's assessment of what work is required?	Yes – see below One of the areas of such work may be assessing the balance sheet liquidity of the entities that make social benefits. The balance sheet liquidity reflects the coverage of liabilities by financial assets and the comparative maturity pattern of such assets and liabilities. The balance of maturity of assets and liabilities of the entity paying social benefits will indicate solvency, that is, the ability to fulfil its commitments with available stock of liquid assets. The balance sheet liquidity can be estimated on the basis of ratio analysis We suggest using the following indicators. Absolute liquidity ratio Formula: Absolute liquidity ratio = (C+CFI)/CL where: C – cash and cash equivalents; CFI – current financial investment, CL – current liabilities and provisions. This ratio shows the part of current liabilities that can be covered immediately by the social benefits entity. It is believed that its value should not be lower than the following threshold: 0.2-0.25. Overall liquidity ratio is calculated by comparing the total amount of current assets to current liabilities: Formula: Overall liquidity ratio = CA/CL where: CA – current assets. This ratio gives a general description of liquidity, showing the level of coverage of current liabilities by current assets. If the ratio value is equal to one, this indicates that the social benefits entity has sufficient current assets to cover its obligations.

Statement on Fiscal Sustainability

Certain types of social benefits transfers rights between groups of citizens. In many cases this is an intergenerational transfer, e.g. a commitment to a state pension imposes an obligation on future generations of citizens, as illustrated in Figure 2 below.

Figure 2: Intergenerational impact of social benefits



The model could be used to identify and measure the long term fiscal sustainability of social benefits. A supplementary statement long term financial sustainability could be used to summarise and report a range of decisions taken today which impact on future generations where these are not reported as actual liabilities in the statement of financial position. Such a supplementary statement could also include other potential intergenerational commitments, e.g. long-term subsidies of specific industries.

A future consultative paper may be required on including in the financial reports such a statement of fiscal sustainability. Issues to be considered would include what would be included in the paper, the extent to which revenue flows should be taken into account (or perhaps the required revenue flows be defined), the use of actuarial data, discount rates, handling of uncertainty, the number of years into the future, and so on.

Response to Consultation Paper on Accounting for Revenue and Non-Exchange Transactions - August 2017, ICGFM

Michael Parry, Chair of the Ad Hoc Committee on International Accounting Standards

Preliminary View	Comments
Preliminary View 1 (following paragraph 3.8) The IPSASB considers that it is appropriate to replace IPSAS 9, Revenue from Exchange Transactions, and IPSAS 11, Construction Contracts with an IPSAS primarily based on IFRS 15, Revenue from Contracts with Customers. Such an IPSAS will address Category C transactions that: (a) Involve the delivery of promised goods or services to customers as defined in IFRS 15; and (b) Arise from a contract (or equivalent binding arrangement) with a customer which establishes performance obligations. Do you agree with the IPSASB's Preliminary View 1? If not, please give your reasons (p. 28)	Agree *Comments.* Combining the two IPSAS is logical. IFRS 15 contains a number of guidelines (including legal) for accounting for exchange transactions. For example, the standard provides provisions on identifying the contract, combination of contracts, contract modification, identifying performance obligations, distinct goods and services, etc. The application of this approach will avoid the issue of classification of exchange revenue and expenses transactions of the kind that, for example, Ukraine encountered while implementing IPSAS 9, 11 and 23.
Preliminary View 2 (following paragraph 3.9) Because Category A revenue transactions do not contain any performance obligations or stipulations, the IPSASB considers that these transactions will need to be addressed in an updated IPSAS 23. Do you agree with the IPSASB's Preliminary View 2? If not, please give your reasons. (p. 28)	Agree *Comments.* In Ukraine, the problem of classification of revenues receipt and implementation of expenses for transfers to citizen was apparent.
Specific Matter for Comment 1 (following paragraph 3.10) Please provide details of the issues that you have encountered in applying IPSAS 23, together with an indication of the additional guidance you believe is needed in an updated IPSAS 23 for: • Social contributions; and/or • Taxes with long collection periods. If you believe that there are further areas where the IPSASB should consider providing additional guidance in an updated IPSAS 23, please identify these and provide details of the issues that you have encountered, together with an indication of the additional guidance you believe is needed. (p. 28)	In Ukraine, the entity that should account for non-exchange transactions was not clear – the administering entity or the Treasury? In Barbados, the lack of any guidance on the treatment of capital grants (i.e. grants for the creation of capital assets) was an issue
Preliminary View 3 (following paragraph 4.64) The IPSASB considers that Category B transactions should be accounted for using the Public Sector Performance Obligation Approach. Do you agree with the IPSASB's Preliminary View 3? If not, please give your reasons. (p. 44)	Agreed *Comments*. The IMF GFS 2014 Para 5.10 states "*transactions are recorded when the underlying activities, transactions, or other events occur that create the unconditional claims to receive the taxes or other types of revenue*". This is consistent with the obligating event approach

Preliminary View	**Comments**
Specific Matter for Comment 2 (following paragraph 4.64) The IPSASB has proposed broadening the requirements in the IFRS 15 five-step approach to facilitate applying a performance obligation approach to Category B transactions for the public sector. These five steps are as follows: Step 1 – Identify the binding arrangement (paragraphs 4.29 - 4.35); Step 2 – Identify the performance obligation (paragraphs 4.36 - 4.46); Step 3 – Determine the consideration (paragraphs 4.47 – 4.50); Step 4 – Allocate the consideration (paragraphs 4.51 – 4.54); and Step 5 – Recognize revenue (paragraphs 4.55 – 4.58). Do you agree with the proposals on how each of the IFRS 15 five-steps could be broadened? If not, please explain your reasons (p. 44)	We consider the IFRS 15 approach equally valid for governments, though explanation and examples of its application would be very useful
Specific Matter for Comment 3 (following paragraph 4.64) If the IPSASB were to implement Approach 1 and update IPSAS 23 for Category B transactions, which option do you favour for modifying IPSAS 23 for transactions with time requirements (but no other stipulations): a. Option (b) – Require enhanced display/disclosure; b. Option (c) – Classify time requirements as a condition; c. Option (d) – Classify transfers with time requirements as other obligations; or d. Option (e) – Recognize transfers with time requirements in net assets/equity and recycle through the statement of financial performance. Please explain your reasons. (p. 44)	Option (e) This is the only approach which is consistent with accrual principles
Specific Matter for Comment 4 (following paragraph 4.64) Do you consider that the option that you have identified in SMC 3 should be used in combination with Approach 1 Option (a) – Provide additional guidance on making the exchange/non-exchange distinction? • Yes • No Please explain your reasons. (p. 44)	Yes Additional information would be needed to understand the transaction

Preliminary View	Comments
Preliminary View 4 (following paragraph 5.5) The IPSASB considers that accounting for capital grants should be explicitly addressed within IPSAS. Do you agree with the IPSASB's Preliminary View 4? If not please give your reasons. (p. 45)	Agreed *Comments.* At present, there is no guidance on capital grants, this is an issue
Specific Matter for Comment 5 (following paragraph 5.5) (a) Has the IPSASB identified the main issues with capital grants? If you think that there are other issues with capital grants, please identify them. (b) Do you have any proposals for accounting for capital grants that the IPSASB should consider? Please explain your issues and proposals. (p. 46)	*Main issues are identified* *Comments.* Main issues encountered have been: • Timing of recognition • Treatment of revenue from capital grants
Specific Matter for Comment 6 (following paragraph 5.9) Do you consider that the IPSASB should: (a) Retain the existing requirements for services in-kind, which permit, but do not require recognition of services in-kind; or (b) Modify requirements to require services in-kind that meet the definition of an asset to be recognised in the financial statements provided that they can be measured in a way that achieves the qualitative characteristics and takes account of the constraints on information; or (c) An alternative approach. Please explain your reasons. If you favour an alternative approach please identify that approach and explain it. (p. 47)	We favour an alternative approach (c): services in kind should be recognised if the conditions in (b) apply and in addition "if obtaining the information is cost effective" To calculate the fiscal indicators used for analysis, these services should be excluded from revenues and expenditures. In particular, for the calculation of state final consumption as the element of GDP in the UN System of National Accounts, it is necessary to know whether, and to what extent, such flows are accounted for in the composition of income and expenditure. This is needed for diagnosing the General Government sector impact on economy.
Preliminary View 5 (following paragraph 6.37) The IPSASB is of the view that non-exchange transactions related to universally accessible services and collective services impose no performance obligations on the resource recipient. These non-exchange transactions should therefore be accounted for under The Extended Obligating Event Approach. Do you agree with the IPSASB's Preliminary View 5? If not, please give your reasons. (p. 56)	Agreed
Preliminary View 6 (following paragraph 6.39) The IPSASB is of the view that, because there is no obligating event related to non-exchange transactions for universally accessible services and collective services, resources applied for these types of non-exchange transactions should be expensed as services are delivered. Do you agree with the IPSASB's Preliminary View 6? If not, please give your reasons. (p. 56)	Agreed Such transactions are reflected in SNA in the same way (provision of collective services by General Government Sector). The obligations stay the same.

Preliminary View	Comments
Preliminary View 7 (following paragraph 6.42) The IPSASB is of the view that where grants, contributions and other transfers contain either performance obligations or stipulations they should be accounted for using the Public Sector Performance Obligation Approach (PSPOA) which is the counterpart to the IPSASB's preferred approach for revenue. Do you agree with the IPSASB's Preliminary View 7? If not, please give your reasons (p. 57)	Agreed
Preliminary view 8 (following paragraph 7.18) The Board considers that at initial recognition, non-contractual receivables should be measured at face value (legislated amount) of the transaction(s) with any amount expected to be uncollectible identified as an impairment. Do you agree with the IPSASB's Preliminary View 8? If not, please give your reasons (p. 61)	Agreed
Preliminary View 9 (following paragraph 7.34) The IPSASB considers that subsequent measurement of non-contractual receivables should use the fair value approach. Do you agree with the IPSASB's Preliminary View 9? If not, please give your reasons. (p. 63)	Agreed
Specific Matter for Comment 7 (following paragraph 7.46) For subsequent measurement of non-contractual payables do you support: (a) Cost of Fulfilment Approach: (b) Amortized Cost Approach; (c) Hybrid Approach; or (d) IPSAS 19 requirements? Please explain your reasons. (p. 65)	We support option (a), This is the simplest and most logical approach. It allows the identification of the amount in accordance with the approaches defined by IPSAS 19 "Provisions, contingent liabilities and contingent assets".