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to be held in autumn 2020

Draft EPSAS Screening Report
IPSAS 4 - The effects of changes in foreign exchange rates

Paper by PwC in cooperation with Eurostat
- written consultation -

This document was commissioned by Eurostat. It analyses the consistency of the named IPSAS standard with the draft EPSAS framework, with a view to informing future EPSAS standard setting. This version was prepared taking into account comments received from the participants of the Cell on Principles related to EPSAS Standards.

In advance of the autumn 2020 Working Group meeting, participants are invited to provide written comments on the analysis provided and on the conclusions reached.

Pilot EPSAS screening report

IPSAS 4 - The effects of changes in foreign exchange rates

March 2020

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Background

Objectives

We refer to the general introduction to the pilot EPSAS screening reports that covers the following elements:

- Key objectives of EPSAS.
- Standard setting process in the public sector.
- Purpose and scope of the screening reports.
- Approach of the screening reports.
- European public good.
- Common elements considered when preparing the reports.

General introduction to IPSAS 4

IPSAS 4 is based primarily on International Accounting Standard (IAS) 21 (revised in 2003, as amended in 2005), 'The Effects of Changes in Foreign Exchange Rates' published by the International Accounting Standards Board (IASB). In developing IPSAS 4, the IPSASB applied its 'Process for Reviewing and Modifying IASB Documents' that identifies public sector modifications where appropriate. This approach enables the IPSASB to build on best practices in private sector financial reporting, while ensuring that the unique features of the public sector are addressed.

Main public sector differences between IAS 21 and IPSAS 4 are summarised below[1]:

- Commentary additional to that in IAS 21 has been included in paragraphs 1, 11, 13, 26, 43, 45, 67, 68, 72 of IPSAS 4 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 4 contains an additional transitional provision allowing an entity, when first adopting IPSASs, to deem cumulative translation differences existing at the date of first adoption of accrual IPSASs as zero (paragraph 67). This transitional provision is adapted from IFRS 1, "First-time Adoption of International Financial Reporting Standards."
- IPSAS 4 uses different terminology, in certain instances, from IAS 21. The most significant examples are the use of the terms revenue, economic entity, statement of financial performance and net assets/equity in IPSAS 4. The equivalent terms in IAS 21 are income, group, statement of comprehensive income and equity.

There are no significant current projects that could have an impact on IPSAS 4.

1 Refer to the IPSAS-IFRS Alignment Dashboard regularly updated by the IPSASB available on https://www.ifac.org/system/files/uploads/IPSASB/Agenda%20Item%201.5%20IPSAS%20IFRS%20Alignment%20Dashboard_June%202019.pdf[1]

The objective of the standard is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency. The principal issues are (a) which exchange rates to use and (b) how to report the effects of changes in exchange rates in the financial statements.

Scope of the report

The present screening report analyses the requirements applicable to foreign currency transactions and foreign operations in the financial statements and the methodology of translation of financial statements into a presentation currency.

The standard does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. Accordingly, entities may apply the relevant international or national accounting standards dealing with hedge accounting.

Reference to EFRAG assessment

No specific individual technical assessment of IAS 21, the IFRS equivalent of IPSAS 4, was carried out by the EFRAG, and therefore no specific individual endorsement report was produced.

The EFRAG however provided on 19 June 2002 a positive assessment of all IAS standards existing at 1 March 2002, including IAS 21, as part of the overall introduction of IAS within the EU.

In addition, the EFRAG issued in 2006 a separate endorsement advice on the amendment 'Net investment in a foreign operation' applicable as from annual periods beginning on or after 1 January 2006. In this amendment, the IASB reflected the following decisions:

- As regards a monetary item that forms part of an entity's investment in a foreign operation, the IASB concluded that the accounting treatment in consolidated financial statements should not be dependent on the currency of the monetary item.

- Also, the accounting should not depend on which entity within the group conducts a transaction with the foreign operation.

EFRAG concluded that the amendment is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

The IPSASB developed this revised IPSAS 4 considering IASB's amendment to IAS 21 (published as Net Investment in a Foreign Operation) in December 2005 to converge public sector accounting standards with private sector standards to the extent appropriate.

Reference to EPSAS issue papers and other EPSAS preparatory work

The PwC study of 2014[2] analysed the suitability of the IPSAS standards as a basis for developing EPSAS. Following this analysis, IPSAS 4 was classified into category 3: 'Standards that might be implemented with minor or no adaptation'. Standards falling under this category were assessed to be acceptable for use by EU Member States without adaptation or with only minor adaptation.

During the course of developing the technical proposal on EPSAS, Eurostat commissioned a series of twenty technical issues papers (IPs), which analyse in particular key public sector specific accounting issues. The papers were discussed at the EPSAS Working Group meetings during 2016-2018. The papers are all publicly available on Eurostat's website. Two EPSAS IPs addressing financial instrument topics were produced in 2018. The topics covered were the accounting treatment of loans and borrowings on the one hand, and the accounting treatment of financial guarantees on the other hand.

Each of the IPs seek to identify conclusions and key issues for further discussion. Taking into consideration the analyses provided in the IPs and the initial views exchanged with Member States' public sector accounting experts during the Working Group meetings, Eurostat drew tentative conclusions that may serve, together with the IPs themselves, as considerations for future standard setting.

No EPSAS issue paper was prepared on the topic of the effect of changes in the foreign exchange rates.

[2] See PwC, Collection of information related to the potential impact, including costs, of implementing accrual accounting in the public sector and technical analysis of the suitability of individual IPSAS standards, 2013/S 107-182395, 1 August 2014

Screening of IPSAS 4 'The effects of changes in foreign exchange rates' against criteria set in the draft EPSAS framework

Introduction

The EPSAS criteria listed in the draft EPSAS framework have been used to perform an assessment of IPSAS 4 'The effects of changes in foreign exchange rates'. The standard replaced IPSAS 4 (issued December 2006) and is effective for annual reporting periods beginning on or after 1 January 2010.

In order to develop recommendations, one should first consider whether IPSAS 4 would meet the qualitative characteristics of the draft EPSAS CF, i.e. whether it would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information and would not be contrary to the true and fair view principle.

This report considers the requirements of IPSAS 4 applicable to the accounting for the effect of changes in the foreign exchange rates, for each of the qualitative characteristics of the draft EPSAS CF.

Further, this paper includes a high-level comparison between the requirements of IPSAS 4 and other international accounting and financial reporting frameworks applied by the public sector entities in various jurisdictions, such as IFRS, ESA 2010 and EU Accounting Rules, bearing in mind the objective of alignment, reduction of cost of implementation and compliance cost.

Finally the paper assesses whether IPSAS 4 would be conducive to the European public good.

The findings are presented below and the conclusion is included in the last section of this report.

Conformity with Qualitative Characteristics

Relevance

The standard deals with transactions denominated in a currency other than the entity's functional currency.

Under IPSAS 4, a foreign currency transaction should be recorded on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.

The functional currency is normally the currency of the environment in which the entity generates and expends cash. Factors to consider when determining an entity's functional currency are discussed in the following chapters.

At each reporting date, the entity must translate foreign currency monetary items using the closing rate. Exchange differences arising on settlement of monetary items and on translation of monetary items at a rate different from when initially recognised are recorded in surplus or deficit. Important to mention that the closing rate is the spot exchange rate at the balance sheet date. An exchange rate that is fixed under the terms of the relevant contract cannot be used to translate monetary assets and liabilities. Translating a monetary item at the contracted rate under the terms of a relevant contract is generally not permitted under IPSAS.

Non-monetary items that are measured in a foreign currency are kept at the exchange rate at the date of the transaction. Typical examples of non-monetary items are: intangible assets, goodwill, property, plant and equipment, inventories, amounts pre-paid for goods and services, equity investments etc.

A foreign exchange gain or loss occurs when transactions are payable or receivable in a foreign currency (these receivables or payables are monetary items) and exchange rates change between the time of recognition of the transaction and the time of payment. Such gains or losses may be realised (when settlement occurs) or unrealised at the end of the reporting period.

Key disclosures include the amount of exchange differences recognised in surplus or deficit, making no differences between realised and unrealised foreign exchange differences. It should however be mentioned that IPSAS 2 requires presentation of unrealised gains and losses arising from changes in foreign currency exchange rates on cash and cash equivalents held or due in a foreign currency in a separate line item.

Faithful representation / Reliability

When several exchange rates are available, the standard is clear: the rate used to measure assets and liabilities denominated in a foreign currency is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date (IPSAS 4.30).

The information required by IPSAS 4 could lack reliability when there is a long-term lack of exchangeability. The standard has no specific guidance to address such circumstances. The general principles and requirements in the IPSAS 4 and the draft EPSAS CF provide an adequate basis for an entity to assess whether, in these circumstances, it uses the official exchange rate(s) to translate into its presentation currency the results and financial position of a foreign operation. This is not expected to happen frequently in the European environment. The notion of faithful representation and reliability in the draft EPSAS CF is supported by the qualitative characteristics of completeness, prudence, neutrality, verifiability and substance over form. These are separately discussed below.

Completeness

Many reporting entities comprise a number of individual entities (e.g. an economic entity is made up of a controlling entity and one or more controlled entities). Various members of an economic entity may have investments in associates or joint ventures or branches in foreign jurisdictions.

It is necessary for the results and financial position of each individual entity included in the reporting entity to be translated into the currency in which the reporting entity presents its financial statements. The standard permits the presentation currency of a reporting entity to be any currency.

The results and financial position of any individual entity within the reporting entity whose functional currency differs from the presentation currency are translated in accordance with clear methodology defined in IPSAS 4.

For completeness of the accounting at the level of the reporting entity, any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation are treated as assets and liabilities of the foreign operation. Thus they are expressed in the functional currency of the foreign operation and shall be translated at the closing rate (IPSAS 4.56).

Prudence

As mentioned before, the standard distinguishes the following steps when calculating the effect of the foreign exchange rates:

First, an entity should determine its functional currency – the currency of the primary economic environment in which the entity operates. Next, an entity translates all foreign currency items into the functional currency:

- at date of transaction, use spot exchange rate for initial recognition and measurement;

- at subsequent reporting dates: use closing rate for monetary items; use transaction-date exchange rates for non-monetary items carried at historical cost; and use valuation-date exchange rates for non-monetary items that are carried at fair value.

Foreign exchange differences arising on settlement of monetary items and on translation of monetary items at a rate different from when initially recognised are included in surplus or deficit, with one exception:

'Foreign exchange differences arising from monetary items that form part of the reporting entity's net investment in a foreign operation (often called "quasi-equity loans") are recognised in the consolidated financial statements that include the foreign operation in a separate component of net assets/equity; these differences will be recognised in the surplus or deficit on disposal of the net investment.'

The rationale behind this approach is that a monetary item receivable from or payable to a foreign operation for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation and should be accounted for the same way (so called 'quasi-equity loan').

This is a prudent approach, because monetary items that form part of the net investment in a foreign operation in substance form part of a long-term investment. Under this approach, no unrealised foreign exchange gains/losses are presented in the surplus/deficit until the date of disposal of the investment itself. It also best reflects the substance of the transaction.

The standard however is not clear on how to deal with the exchange gains and losses accumulated in net assets/equity upon redemption of the quasi-equity loan. The standard could specify whether such repayment should trigger recycling of the exchange gains or losses into the surplus or deficit or not.

IPSAS 4 lacks guidance on the reclassification of the foreign currency translation reserve when a repayment of a foreign investment occurs. For example, it is not clear whether the foreign currency translation reserve (FCTR) should be recycled for transactions in which there is a reduction in:

- the investor's percentage equity ownership in the investee (a relative reduction); or

- the absolute investment in the investee, even if there is no reduction in the proportionate equity ownership interest.

IPSAS 4 para 57 states: 'On the disposal of a foreign operation, the cumulative amount of the exchange differences deferred in the separate component of net assets/equity relating to that foreign operation shall be recognised in surplus or deficit when the gain or loss on disposal is recognised.'

How an entity applies the requirements in paragraph 57 is largely dependent on whether it interprets “a disposal” to mean an absolute reduction, a proportionate reduction, or both. Different interpretations could lead to diversity in practice in the application of IPSAS 4 on the reclassification of the FCTR when repayment of investment in a foreign operation occurs.

Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. This means that such assets are recorded at historical cost, and no re-translation of the asset is required at subsequent balance sheet dates. However, if the asset is impaired, the recoverable amount is translated at the exchange rate ruling at the date when that value was determined (for example, the closing rate at the balance sheet date). This results in the timely recognition of impairment losses in the financial statements of the investor.

Consistently, non-monetary assets that are measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined. Changes in fair value include foreign exchange differences arising on the re-translation of the opening foreign currency fair value.

Neutrality

IPSAS 4 provides consistent and neutral guidance on how to determine an entity’s functional currency and how to deal with any subsequent changes in the functional currency, following significant changes in economic facts, events and conditions.

IPSAS 4 provides guidance on how to determine an entity’s functional currency, because judgement might be required. In particular, it might be difficult to deal with mixed indicators.

An entity’s functional currency is defined as “the currency of the primary economic environment in which the entity operates” (IPSAS 4.10). The primary economic environment is normally the economic environment in which the entity primarily generates and expends cash. The functional currency is normally the currency of the country in which the entity is located, however this is not always the case.

Once the functional currency of an entity is determined, it should be used consistently, unless significant changes in economic facts, events and conditions indicate that the functional currency has changed.

A change in functional currency is accounted for prospectively from the date of change (IPSAS 4.40). Management should translate all items into the new functional currency, using the exchange rate at the date of change. Because the change was brought about by changed circumstances, it does not represent a change in accounting policy and, therefore, a retrospective adjustment is not appropriate.

As all assets and liabilities are translated using the exchange rate at the date of change, the resulting translated amounts for non-monetary items are treated as their historical cost. Exchange differences arising from the translation of a foreign

operation previously recognised in net assets/equity are not reclassified from equity to surplus or deficit until the disposal of the operation.

Verifiability

In most cases, the application of IPSAS 4 requirements can be easily verified based on published exchange rates.

One aspect to consider might be the source of verifiable evidence needed to support the “intention” of an entity not to require settlement “in the foreseeable future”. Based on the current guidance, there are no restrictions that should prevent classification of an item from the “quasi-equity loan” category.

Substance over form

IPSAS 4 (as a principle-based standard) is designed to reflect the substance of economic phenomena instead of merely providing information about their legal form. For example, as mentioned above, exchange differences arising on ‘quasi-equity loans’ re reported in net assets/equity. In case the legal form differs from the substance of an economic phenomenon, relevant information is provided in order for the users to understand the difference.

Based on our assessment, we have not identified areas where the principle-based requirements of IPSAS 4 would deviate from the QC of Substance over form.

Where normal transactions take place between group entities located in different countries, exchange differences are reported in the entity’s surplus or deficit in the same way as gains or losses on transactions arising with third parties. The exchange difference arising simply reflects the risk of doing business with a foreign party, even though that party happens to be a group member. This is consistent with the substance of the transactions because the monetary item represents a commitment to convert one currency into another and exposes an entity to gain or loss through currency fluctuations. This situation is however expected to be rare for governments.

Understandability

The assessment of this QC depends on the level of complexity of the existing processes and models currently in place in the public sector entity.

Based on our assessment, complexity of some of the requirements of IPSAS 4 does not impair understandability, assuming users have a reasonable knowledge of accounting and financial reporting. Therefore, the standard meets the understandability QC.

Comparability

The requirements in IPSAS 4 to translate at the closing rate the assets and liabilities denominated in a foreign currency, are clear and should not affect the comparability QC.

IPSAS 4 para 11-16 provide factors to be considered in determining the functional currency of an entity. Para 14 states that 'when the above indicators are mixed and the functional currency is not obvious, management uses its judgment to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions'. As part of this approach, management gives priority to the primary indicators in paragraph 11 before considering the indicators in paragraphs 12 and 13, which are designed to provide additional supporting evidence to determine an entity's functional currency.

In addition, para 20 of IPSAS 4 requires that an entity determines its functional currency in accordance with para 11-16 of the standard. Therefore, the 'primary indicators' in para 11 should not be considered in isolation when determining the functional currency of an entity.

IPSAS 1 "Presentation of Financial Statements" requires disclosure of significant accounting policies and judgements that are relevant to an understanding of the financial statements. Additional application guidance could be provided to address the circumstances where determination of functional currency requires a significant degree of judgment.

For EU governments, the functional currency is expected to be in virtually all cases the currency of the Member State and the above possible complexities will not apply.

The standard is silent on how to translate items that are recognised directly in net assets/equity (that is, items that have not been recognised through the surplus or deficit). These will generally be recognised as a result of a transaction with equity holders. As a result, it appears that the standard allows a choice of using either the historical rate or the closing rate for these items. The standard-setter could consider additional guidance in order to achieve comparable outcomes.

Alignment with other frameworks

ESA 2010

Alignment with ESA reporting is desirable, to avoid the burden of a dual reporting in the public sector. Differences with ESA reporting requirements should be avoided where possible, both regarding the scope of entities to be included in the IPSAS scope of reporting and the IPSAS requirements in terms of measurement and disclosures. Applying IPSAS 4 requirements should be acceptable for ESA 2010 purposes.

Under ESA 2010 paragraph 10.27 the nominal holding gains and losses (K.7) - realised or not - on an asset are the increases or decreases in the asset's value accruing to its economic owner as a result of increases or decreases in its price, including exchange rate movements. This treatment of the (financial) assets and liabilities denominated in foreign currency is consistent with IPSAS 4 requirements. There are no specific requirements for monetary items that form part of a net investment in the foreign operation.

ESA 2010 paragraph 6.64 specifies: ‘the value of assets and liabilities denominated in foreign currency is measured by their current market value in foreign currency converted into national currency at the current exchange rate’.

Nominal holding gains and losses may therefore occur from both changes in the price of the asset and the exchange rate. The total value of the nominal holding gains and losses accruing over the accounting period is calculated by subtracting the value of transactions and other volume changes from the difference between the opening and closing balance sheet values.

For this purpose, transactions in assets and liabilities denominated in foreign currency are converted into the national currency using the exchange rates at the time the transactions occur, while the opening and closing balance sheet values are converted using the exchange rates prevailing at the dates to which the balance sheets relate. This implies that the total value of the transactions as net acquisitions - acquisitions less disposals - expressed in foreign currency is, in effect, converted by a weighted average exchange rate in which the weights are given the values of transactions conducted on different dates.

IFRS[3]

IPSAS 4 ‘The Effects of Changes in Foreign Exchange Rates’ is drawn primarily from IAS 21 ‘The Effects of Changes in Foreign Exchange Rates’ (revised in 2003, as amended in 2005), with only insignificant differences.

EU Accounting Rules

EU Accounting Rule (AR) 13 prescribes how to include foreign currency transactions and foreign operations in the financial statements of the European Union and how to translate financial statements into a presentation currency. EU AR 13 (2009) requirements are aligned with IPSAS 4.

[3] Refer to the IPSAS-IFRS Alignment Dashboard regularly updated by the IPSASB available on https://www.ifac.org/system/files/uploads/IPSASB/Agenda%20Item%201.5%20IPSAS%20IFRS%20Alignment%20Dashboard_June%202019.pdf

European Public Good

Assessing whether IPSAS 4 is conducive to the European public good

The assessment of whether IPSAS 4 would be conducive to the European public good addresses the following items:

a) Whether the standard will improve financial reporting;
b) The costs and benefits associated with the standard; and
c) Whether the standard could have an adverse effect to the European economy, including financial stability and economic growth.

These assessments will allow the EU authorities to draw a conclusion as to whether the standard is likely to be conducive to the European public good.

The analysis revealed no reasons why IPSAS 4 would not be conducive to the European public good:

- IPSAS 4 will contribute to improving financial reporting when compared to heterogeneous reporting requirements currently applied in the EU.

- The information needed for the application of IPSAS 4 can be available in a timely manner with no undue cost or efforts. Implementation of the standard may result in moderate one-off costs and should be relatively cost neutral on an ongoing basis for preparers. The benefits derived from the improvements should outweigh the costs.

- The above does not lead to conclude that implementation of IPSAS 4 would not be conducive to the objectives of the European public good.

Conclusion

Assessing IPSAS 4 against the criteria formulated in the draft EPSAS framework

The analysis has not revealed major conceptual issues with IPSAS 4 and has not identified any inconsistency between IPSAS 4 and the draft EPSAS framework.

Following the screening analysis summarised in the present report, the future standard setter could consider following conclusions. The information resulting from the application of IPSAS 4:

- would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information needed for making economic decisions and achieving the necessary level of financial transparency and comparability of financial reporting in the European Union;
- would not be contrary to the true and fair view principle; and
- would be conducive to European public good.

In order to achieve consistent application of the new standard within the EU context and therefore better address the comparability objective of EPSAS financial statements, guidance is desirable in the following areas:

- *Judgment and comparability*. The use of judgment and estimates is inherent in the preparation of financial statements and may to some extent, in a limited number of cases, affect the comparability of financial statements.

- *Recycling requirements*. Further guidance could be developed on how to deal with the exchange gains and losses accumulated in net assets/equity upon redemption of a quasi-equity loan denominated in a foreign currency. The standard could specify whether such repayment should trigger recycling of the exchange gains or losses into the surplus or deficit or not.

- *Translation of items recognised in equity*. IPSAS 4 is silent on how to translate items that are recognised directly in net assets/equity (that is, items that have not been recognised through the surplus or deficit). As a result, it appears that the standard allows a choice of using either the historical rate or the closing rate for these items. The requirements could be more specific in this area.

The analysis has not identified any adverse effect of the standard to the European economy, including financial stability and economic growth, or any other factors that would mean the standard is not conducive to the European public good.

The future standard setter could consider the conclusions of this assessment and likely net benefit of using the requirements of IPSAS 4 as a starting point in

implementing the equivalent EPSAS, considering the need for additional guidance in some areas.