

# **Working towards a common accounting framework for monetary gold**

**Kenneth Sullivan, 25 May 2016**

**All material in this presentation represents the opinion of the speaker**

# Contents

- Reasons for central banks holding gold
- Problems for central bank reporting of monetary gold
- Central bank responses
- Paper's recommendations

# Reasons central banks hold gold

- Historical precedent – gold standard backing for currency
- As an element of foreign exchange assets
- Central banks hold significant volumes of gold so accounting for it matters

# Accounting for gold is a long-standing issue

- Little common practice around the world in both accounting and disclosure
- Parked in the 'too difficult' box
- Audit firms also happy for it to be parked, as they were accepting differing treatments around the world – in many cases an “immaterial item”
- ESCB had to achieve an agreed policy in the 1990s.
- Important as central banks are some of the few entities that hold gold in significant quantities
- And hold it for different reasons compared to other entities
- Issue been around for a long time
- In 2015, the World Gold Council decided to open the issue by commissioning a paper

# Monetary gold as a foreign reserve asset

- Central banks hold gold for investment rather than trading – long term horizons
- Gold may serve as hedge to USD volatility
- Short term price volatility tends to create “noise” that may conflict with medium term investment strategies
- Central banks should account for gold in the broader context of their foreign reserves portfolio
- Gold as a long term asset with short term volatility provides a good example of issues arising from accounting under IFRS.

# Why does accounting for gold matter?

- We don't want the accounting tail wagging the policy dog
  - Accounting treatment can influence investment decisions
- IFRS explicitly excludes treating monetary gold as a financial instrument
- IMF requires reporting of monetary gold at “fair value” as with all FX
- Central banks don't like unrealized price volatility passing through P&L
  - Risks overstating profits – poor basis for distributions
  - Distorts performance measurement
- BUT they do like hedging effect on balance sheet
  - Reduces volatility
  - Protects “capital”
- Range of responses:
  - Provide better measure of functional performance
  - While still gaining clean audit opinion under IFRS

# Background for paper

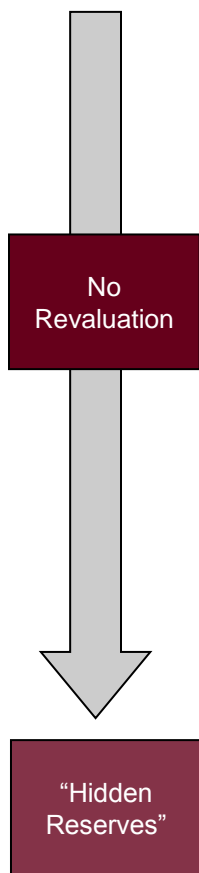
- Objective - to propose a common gold accounting framework for central banks
- Used published central bank financial statements of gold holding banks
  - 69/100 disclosed sufficient information (In English) to be useful
- Grouped by
  - Valuation
  - Treatment of revaluations
  - Impact on distributions
- Significant variety in treatments
- Most used fair value (60 of 69)
- Greatest variation lies in treatment of revaluations

# Summary of findings

| <b>Method</b>   | <b>Number of Central Banks</b> |
|---|--------------------------------|
| <b>1. Cost</b>  | 9                              |
| <b>2. Fair Value through Profit and Loss (FVTPL)</b>                        | 3                              |
| <b>3. Fair Value to Reserves via Profit</b>                                 | 11                             |
| <b>4. Fair Value to Reserves through Other Comprehensive Income (FVOCI)</b> | 14                             |
| <b>5. Fair Value Direct to Reserves</b>                                     | 7                              |
| <b>6. Fair Value Direct to Non-Equity Revaluation Account</b>               | 25                             |
| <b>7. “Financial” Fixed Asset</b>   | 0                              |

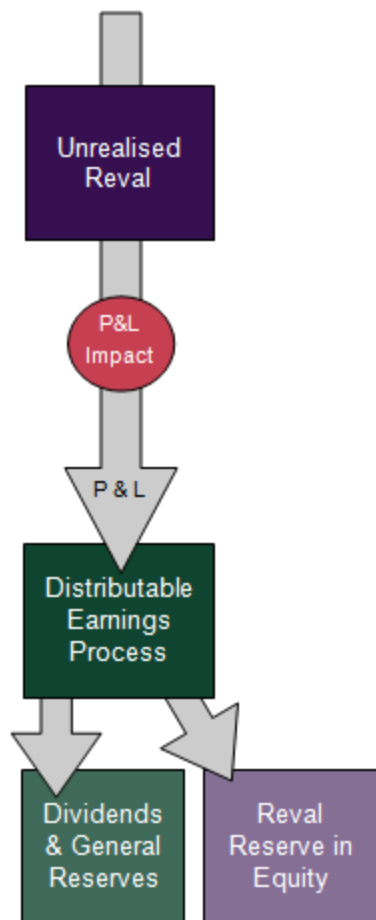


# At cost



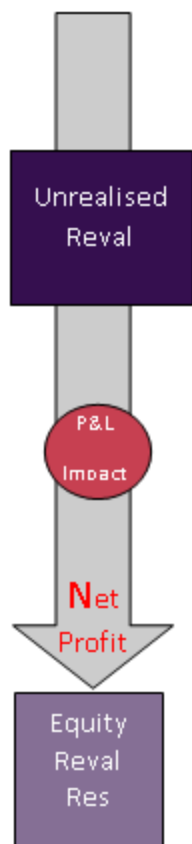
- Gold stated at national currency value applying at time of purchase
  - no recurring impact on financial statements
- Price and FX Revaluations accumulate as “hidden reserves”
- Fully IFRS compliant
  - IAS 2: requires recognition of commodities at cost
- Conceptual argument exists supporting use due to central bank's ability to influence both exchange rate and interest rate that can directly impact asset value
- However, most banks believe enhanced transparency has better informational effects
- Need to seek compliance with IMF BoP disclosures
- Central banks adopting - 9

# Fair Value through Profit and Loss (FVTPL)



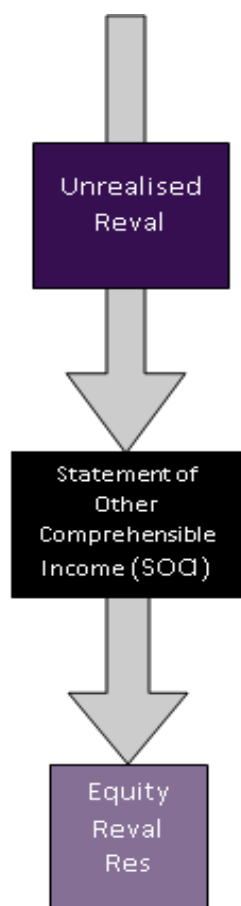
- Revaluations disclosed through operating income section of consolidated statement of profit and loss and comprehensive income
- Gold stated at current fair value
- Aggregated with realized income and included in calculation of distributable earnings
- Equivalent to accounting for gold as a currency
- Non-compliant with IFRS
  - IAS 39/IFRS 9 defines gold bullion as a commodity that should be accounted at cost
  - Does it meet IAS 21 definition as a foreign currency?
  - If it does then accounting complies with IAS 21 requirements to report fair value changes through profit and loss
- Central banks adopting - 3

# Fair Value to Reserves via Profit and Loss



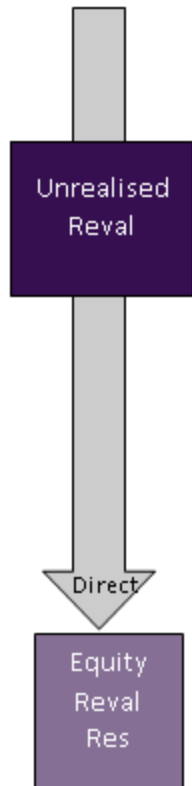
- Revaluations disclosed through operating income section of consolidated comprehensive income statement
- Unrealized revaluations included in reported net profit (loss) figure
- *Specific legal clauses or regulations required to explicitly exclude revaluations from inclusion in distributable earnings*
- Best approach for treating gold as currency
- Non-compliant with IFRS
  - IAS 39/IFRS 9 defines gold bullion as a commodity that should be accounted at cost
  - Accounting for monetary gold as a currency complies with IAS 21 requirements to report fair value changes through profit and loss
- Central banks adopting - 11

# Fair Value to Reserves via OCI



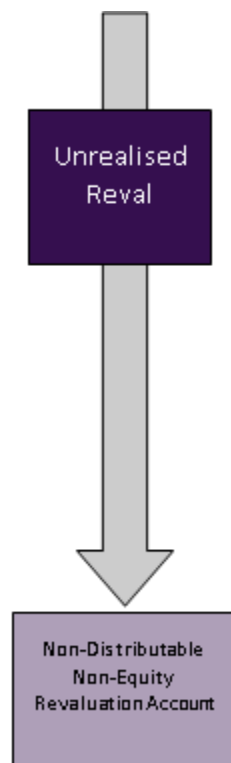
- Gold treated as financial asset in nat'l currency and revaluation combines commodity and FX elements as single price change
  - parallels treatment of available for sale (AFS) assets (under IAS 39)
- Unrealized revals included in other comprehensive income, not profit
- *Excludes unrealized revaluations from distributable earnings (held in equity) – no legal clause required*
- Non-compliant with IFRS
  - IAS 39/IFRS 9 defines gold bullion as a commodity that should be accounted at cost
  - IAS requires monetary items to report FX revals through P&L
  - However, consistent with assets classed as FVOCI (AFS - IAS 39)
- Central banks adopting – 14

# Fair Value Direct to Reserves



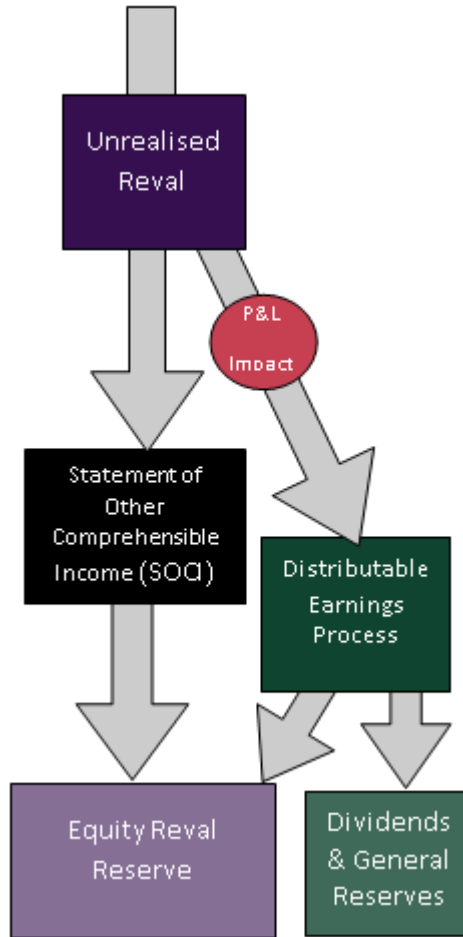
- Gold reported at fair value but revaluations allocated directly to reserve in equity
- *Directly removes revals from any considerations of profit or distributions*
- Non-compliant with IFRS
  - No equivalent IFRS treatment for financial instruments
  - No IFRS sanctions direct allocation of financial asset valuations to reserves
- Disclosure through Statement of Changes in Equity deemed inappropriate as valuation changes are not a direct transaction with shareholders
- Central banks adopting – 7

# Fair Value Direct to Non-Equity Account (ESCB)



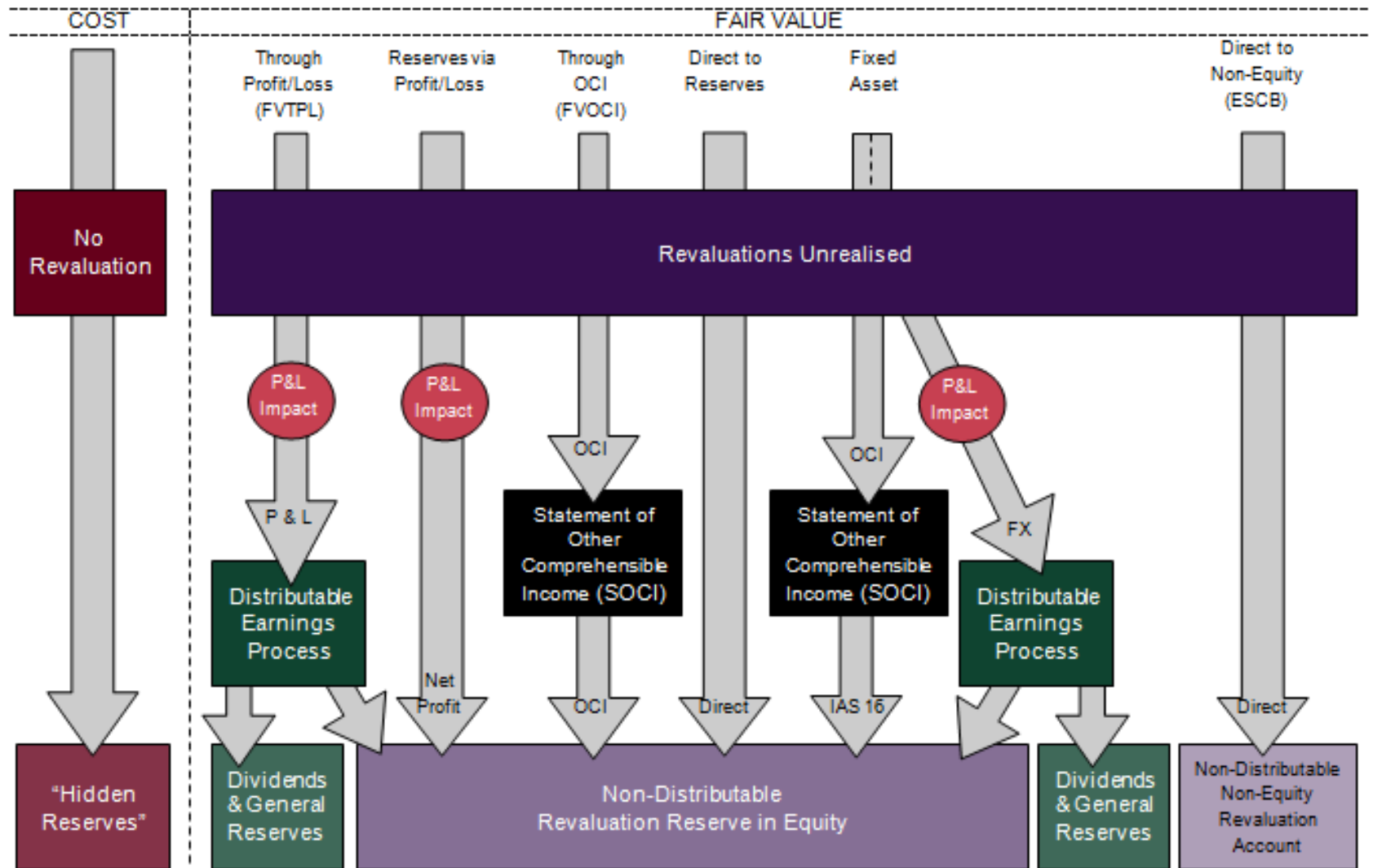
- Gold reported at fair value, but unrealized revals assigned directly to non-equity account
- Adopted by European System of Central Banks (ESCB)
- *Unrealized revals bypass all elements of net profit and capital - consistent with ESCB framework, which considers provisions as specific buffers for gold valuation volatility*
- Non-compliant with IFRS
  - Revaluation provisions account doesn't meet IFRS definition of liability
  - Equates gold to foreign currency but non-compliant with IAS 21 in non-reporting of FX revals thru P&L,
  - non-compliant with IAS 39/IFRS 9 in allocation directly to non-equity valuation accounts
- Central banks adopting – 25

# Fixed Asset



- Gold accounted for under IAS 16 - the standard for property, plant, and equipment (fixed assets)
- Example separately accounts for asset and FX changes
  - Asset price revalued and reported through OCI (same as FVOCI)
  - FX accounted for under IAS 21 with change in FX at purchase and closing date reported through P&L
- *Specific legal clauses or regulations required to explicitly exclude unrealized FX revaluations from inclusion in distributable earnings*
- Potentially IFRS compliant if gold seen as fixed asset - (IAS 21), asset seen as non-monetary item both price and FX revaluation reported thru OCI
- Central banks adopting – 0

# Summary of current practices





# Proposed common approach

- Treat gold as a financial instrument denominated in national currency
- Recognize value changes as single item at fair value through other comprehensive income
- Benefits of this approach
  - Reports fair value on balance sheet (hedge effect)
  - Discloses unrealized revaluations in OCI as single revaluation
  - Allocates revaluations to revaluation equity account
    - No split between FX and price
  - Excludes revaluations from considerations for dividends
  - Allows reporting of realized gains and losses through profit and loss
- Consistent with treating gold as a non monetary FX asset

# Other issues discussed in paper

- Not Reporting Realized Revaluation Gains Through Profit And Loss
- The Treatment of Debit Balances in revaluation reserves
- Disclosures Regarding Gold Holdings in Financial Statements
- Cost of Sales for Monetary Gold
- How Central Banks Account For Non-Monetary Gold

# Conclusion

- Paper offers common approach
- Not IFRS compliant, but
- Consistent with IFRS concepts
- Consistent with central bank objectives
- Achieves greatest level of transparency
- Aligns with central bank capital maintenance concerns
- Widespread common adoption will provide defense against audit qualifications

# What now?

- Paper published
- Interested parties to debate
- Feedback to the World Gold Council

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# Questions & discussions

