exposure draft

PUBLIC SECTOR ACCOUNTING BOARD
PROPOSED ACCOUNTING STANDARDS

Financial Instruments

September 2009

COMMENTS MUST BE RECEIVED BY JANUARY 15, 2010

This Exposure Draft is issued by the Public Sector Accounting Board. The members of the Board are drawn from government, public accounting, business and academe. All members serve as individuals and not as representatives of their governments, employers or organizations.

Individuals, governments and organizations are invited to send written comments to the Board on the Exposure Draft proposals. Comments are requested from those who agree with the Exposure Draft as well as from those who do not.

All comments received will be available on the website at www.psab-ccsp.ca ten days after the comment deadline, unless confidentiality is requested.

To be considered, comments must be received by January 15, 2010, addressed to:

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Toronto, Ontario M5V 3H2

A PDF response form has been posted with this document to assist you in submitting your comments. Alternatively, you may send comments by e-mail (in Word format), to: ed.psector@cica.ca

Public Sector Accounting Standards, Guidelines and Recommended Practices need not be applied to immaterial items. Materiality is a matter of professional judgment in the particular circumstances. Materiality may be judged in relation to the reasonable prospect of its significance in the making of assessments and judgments by the users of financial statements. A material item would be expected to affect assessments of and judgments on government financial operations and management.

Highlights

The Public Sector Accounting Board (PSAB) proposes, subject to comments received following exposure, to issue a new CICA Public Sector Accounting Handbook Section, FINANCIAL INSTRUMENTS. The Section would apply to all levels of government.

This Exposure Draft (ED) sets out the text of a proposed standard that would apply to the reporting of derivative and non-derivative financial instruments by a government. Responses are requested by December 11, 2009.

Background

What is a financial instrument?
Simply stated, a financial instrument is a contract between entities that gives rise to a financial resource (an asset) for one entity and a financial obligation (a liability) or equity interest for another entity. Financial instruments can be basic, such as an account receivable or an account payable, others are more complex, such as derivatives.

Why should governments report on financial risks and derivatives?
Economic events affect all those who enter into and rely upon financial contracts. Governments issue debt obligations upon which others rely and hold financial assets subject to credit and other risk factors. Providing information to financial statement users about risks associated with both common and complex financial contracts has gained widespread acceptance.

Will fair value measurement improve financial reporting by governments?
When the future obligations or cash flows associated with items are open to significant variation because of market or other risk factors, the usefulness of traditional financial reporting measures, such as cost-based information, is diminished. For this reason, there is an international consensus that the measurement of derivatives and equity instruments should be based on fair values at the financial statement date. Adoption of these provisions will enhance the measure of a government's financial position in a manner consistent with the high transparency required of entities that are issuers of securities.

How will this impact on the measure of surplus/deficit?
The period's surplus or deficit is an important accountability measure. Equally important is the accountability provided when the actual results are compared to the budget plan. These proposals retain the measures provided at present and enhance the information available to readers. When fair value measurement applies, there is a gain or loss due to the remeasurement. Although these remeasurement gains and losses are not realized, they provide useful information about the financial effects of economic events. To support meaningful budget to actual comparisons, they will be distinguished from other revenues and expenses. In each period, the surplus/deficit excluding remeasurement gains and losses will be reported as well as the surplus/deficit based on all changes in the values of assets and liabilities.

Illustration

($ millions)	20X1 Budget	20X1 Actual	20X0 Actual
Revenues (listed by type)	14,277	16,322	16,854
Expenses (listed by function or program)	14,249	14,946	14,303
Surplus/deficit excluding remeasurement gains (losses)	28	1,376	2,551
Remeasurement gains (losses)		(125)	80
Surplus/deficit		1,251	2,631

Summary of key technical features

Purpose and scope
The proposed standard supports reporting on the nature and extent of risks associated with financial instruments held and issued by a government. The rights and obligations that arise from certain contracts a government has entered into are measured. The essence of a financial instrument is the terms within a contract that give rise to a financial resource (an asset) for one entity and a financial obligation (a liability) for another entity. Items that are financial assets can be used to discharge other liabilities or finance future operations. In contrast, non-financial assets are not themselves resources available to settle obligations. Non-financial assets are held by governments pursuant to the provision of a service and are outside of scope.

When reporting on these contracts, a government presents the financial assets and the financial liabilities that flow from them in a transparent manner. It offsets its financial assets and financial liabilities only when legally entitled to do so.

In the case of certain types of contracts, accounting requirements set out in other detailed standards will continue to apply. Generally, financial reporting of leases, loan guarantees, and employer obligations associated with employee future benefits will not be altered. (See paragraph .03 for a list of assets and liabilities that are outside of the scope of these proposals.)

Recognition and measurement
Recognition for financial reporting purposes will generally occur when a government becomes a party to the contract. A financial instrument's value stems from an entitlement to future cash flows. Variability in the future cash flows associated with a simple financial instrument, such as a receivable, is often limited. Risks that can give rise to variability, such as the other party's ability to pay, are readily understood. On the other hand, the future cash flows associated with a derivative are often highly variable, dependent on rates or indexes defined in the contract. This may not be readily apparent to, or easily understood by, financial statement users.

As a contract underlies each derivative, a government that is a party to it will enjoy a benefit or be obligated by its terms. Unlike contingencies, the binding event is the execution of the contract. Future settlements associated with the contract may not be known at the financial statement date but a value based on future cash flows measured in relation to current market information is generally determinable.

Many governments use derivatives to mitigate the risk of fluctuations in interest, currency or other risks that can be expressed in terms of a rate or index. Each government has the flexibility to determine if, when, and to what extent, it will seek

to mitigate economic exposures with derivatives. The use of derivatives gives rise to other risk exposures. These arise from the financial stability of the other party to the agreement ("counterparty credit risk") and the extent to which the timing and amount of cash flows from the derivative will offset variability in the value of the hedged item (often described as "hedge effectiveness").

For these reasons, an international consensus that is reflected in accounting standards issued for both public and profit-oriented sectors is based on measuring derivatives at fair value and presenting them as assets and liabilities in their own right. Debt instruments and derivative contracts would no longer be measured and reported on as a single obligation.

In developing these proposals, broader application of fair value measurement was considered. As non-derivative financial instruments are within the scope, the extent to which fair value measurement would add relevance to the measures of financial position and results was evaluated. This was considered in relation to the information users seek and the complexity of applying the requirements.

PSAB's assessment is that an optimal balance between varied needs can be achieved by applying fair value measurement to those items that typically exhibit a high degree of measurement variability. In line with this objective, equity instruments held as portfolio investments are included in the fair value measurement category. This will apply only to equities quoted in an active market to ensure information is reliable and readily available. All other non-derivative financial instruments will be measured at cost or amortized cost unless a government elects to apply the fair value option.

The fair value option may be applied when a government defines and implements a risk management or investment strategy to manage and evaluate the performance of a group of financial assets, financial liabilities or both on a fair value basis. Governments managing investment portfolios that comprise both equity and debt instruments for long-term returns will be able to reflect fair values in reporting their financial position.

Presentation
Many financial statement users compare results to budget figures. This comparison is a distinguishing feature of public sector financial reporting. When fair value measurement applies, there is a remeasurement gain or loss. Although these remeasurement gains and losses are not realized, they provide useful information about the financial effects of economic events. To support meaningful budget-to-actual comparisons, they are distinguished from other revenues and expenses. As well, PSAB proposes that governments report both their surplus/deficit excluding remeasurement gains and losses as well as surplus/deficit for the period (based on all changes in assets and liabilities). An illustration is provided in paragraph A47.

In adopting this approach, governments will report on the outcomes associated with hedging financial risks in two stages. The economic effects of realized transactions will be reflected in the measure of surplus/deficit excluding remeasurement gains and losses, the component to which budget-to-actual comparisons will apply. When a government has remeasurement gains and losses, these appear on a separate line. For example, a government issues a bond with a variable interest rate and five year term. An interest rate swap is contracted for. Periodic settlements that coincide with interest payments are based on the net difference between the variable rate established in the bond issue and an agreed-upon fixed rate of interest. While the

bond is outstanding, the government reports the variable interest payment and the periodic settlement on the hedging instrument. These two amounts will effectively comprise interest expense and have a corresponding budget figure. At each financial statement date, the fair value of the swap would be reported. The government has either an asset or a liability depending on whether the index or rate upon which the future cash flows are determined is favourable or unfavourable. A valuation technique employing a discounted cash flow methodology is used to establish fair value. Any change in the fair value of the derivative during the reporting period is a remeasurement gain or loss. Remeasurement gains and losses are reported separately on the statement of operations and a comparison to budget is not anticipated.

Derecognition of a financial liability
One requirement in the proposed standard addresses when a financial liability is removed (derecognized) for financial reporting purposes. Debt instruments issued by a government (or an entity controlled by it) may subsequently be reacquired. This requirement, which involves the removal of financial liabilities and the recognition of any related gain or loss, is consistent with existing PSA Handbook requirements that apply to consolidation and inter-organizational bond holdings. This requirement serves to promote consistent financial reporting. Otherwise, liabilities are overstated when a government or an organization controlled by it reacquires a debt instrument as there is no longer an obligation owing to an external party.

Disclosures
These proposals set out disclosures that will assist users in understanding:
- the significance of financial instruments to financial position and changes in financial position; and
- the nature and extent of risks arising from financial instruments that a government is exposed to at the financial statement date.

A government will provide disclosures to support balances reported in the financial statements and specific to the nature and extent of specific financial risks. In the case of the risk disclosures, this analysis may be integrated with the financial statement discussion and analysis when that is part of, and cross-referenced to, a government's financial statements. Specific information requirements are set out in the main body of these proposals. An appendix sets out disclosures that apply when a government designates items for fair value measurement and provides application guidance.

Comments requested

PSAB welcomes comments on all aspects of the Exposure Draft. Comments are most helpful if they relate to a specific paragraph or group of paragraphs, and, when expressing disagreement, they clearly explain the problem and indicate a suggestion, supported by specific reasoning for alternative wording.

For your convenience, a PDF response form has been posted with this document that can be downloaded here. You can save the form both during and after its completion for future reference. Alternatively, written comments may be submitted by e-mail (Word format preferred) to: ed.psector@cica.ca

Please respond to the following questions:

1. Do you agree with the measurement proposals? If not, why not?

2. Do you agree with the fair value option and when it can be applied? If not, why not?
3. Do you agree with the provisions that determine the derecognition of a financial liability? If not, why not?

4. Do you agree with the:
   (a) financial statement disclosures; and
   (b) risk disclosures?
   If not, why not?

5. Remeasurement gains and losses are defined to be revenues and expenses that arise when financial instruments in the fair value category are remeasured. PSAB proposes to amend FINANCIAL STATEMENT PRESENTATION, Section PS 1200, to require:
   (a) a measure of surplus/deficit excluding remeasurement gains and losses on the statement of operations; and
   (b) a measure of surplus/deficit that includes all changes in assets and liabilities.
   Do you agree with this approach? If not, why not?

6. Do you agree with the transitional provisions? If not, why not?

Financial Instruments

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PURPOSE AND SCOPE

.01 This Section establishes standards on how to account for and report all types of **financial instruments** including **derivatives**. Financial instruments include primary instruments (such as receivables, payables and **equity instruments**) and derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps). Derivative financial instruments meet the definition of a financial instrument and, accordingly, are within the scope of this Section.

.02 In this Section, terms that appear in **bold type** are defined in the glossary.

.03 This Section does not apply to:

(a) tax receivables and payables relating to taxes including payments-in-lieu of taxes;

(b) inventories or an asset held for sale according to the criteria in FINANCIAL STATEMENT PRESENTATION, paragraph PS 1200.051;

(c) investments in organizations controlled by a government that are accounted for in accordance with GOVERNMENT REPORTING ENTITY, Section PS 1300;

(d) investments in government partnerships that are accounted for in accordance with GOVERNMENT PARTNERSHIPS, Section PS 3060;

(e) rights and obligations under leases to which LEASED TANGIBLE CAPITAL ASSETS, PSG-2, applies; however, the scope of this exception would not extend to:

(i) requirements to evaluate impairment for the lessor's receivable from the lessee under a direct financing or sales-type lease;

(ii) **derecognition** provisions applicable to the lessee's liability to the lessor under a capital lease; and

(iii) derivatives embedded in leases;

(f) employer's rights and obligations for employee future benefits that are accounted for in accordance with RETIREMENT BENEFITS, Section PS 3250, and POST-EMPLOYMENT BENEFITS, COMPENSATED ABSENCES AND TERMINATION BENEFITS, Section PS 3255;

(g) liabilities that are accounted for in accordance with SOLID WASTE LANDFILL CLOSURE AND POST-CLOSURE LIABILITY, Section PS 3270;

(h) monetary gold;

(i) balances with the International Monetary Fund, whether in the form of subscriptions, notes, or Special Drawing Rights;

(j) liabilities arising from the issuance of currency and coinage;

(k) insurance contracts held or issued by a government, other than freestanding derivative instruments (see paragraph A2);

(l) contracts that require a payment based on climatic, geological or other physical variables that are not traded on an exchange (see paragraph A3); however, this Section applies to derivatives embedded in such contracts;

(m) contracts that require a payment based on specified volumes of sales or service revenues of one of the parties to the contract and that are not traded on an exchange;

(n) guarantees other than loan guarantees accounted for in accordance with LOAN GUARANTEES, Section PS 3310;

(o) loan commitments other than those outlined in paragraph .08; and

(p) contracts to buy or sell non-financial items when quantities are in accordance with a government's expected purchase, sale or usage requirements.

.04 The definition for **financial assets** given in FINANCIAL STATEMENT PRESENTATION, Section PS 1200, applies. However as paragraph .03 establishes, the requirements of this Section do not apply to all financial assets. Certain items, such as inventories for resale and an asset held for sale according to the criteria set out in paragraph PS 1200.051, are physical assets and are excluded from the scope of this Section.

.05 This Section applies to contracts to buy or sell a non-financial item in quantities in excess of a government's expected purchase, sale or usage requirements where contracts can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments.

.06 This Section applies when a financial instrument takes the form of a reinsurance contract principally involving the transfer of **financial risks** and applies to derivatives that are embedded in insurance contracts held by a government.

.07 This Section applies when a financial guarantee contract provides for payments to be made in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that variable is not specific to a party to the contract. For example, a financial guarantee contract that provides for payments to be made if the credit rating of a debtor falls below a particular level is subject to all of the requirements of this Section.

.08 The following loan commitments are within the scope of this Section:

(a) Loan commitments that a government has designated to the **fair value** category — A government that has a past practice of selling the assets resulting from its loan commitments shortly after origination would apply this Section to all its loan commitments in the same class.

(b) Loan commitments that can be settled net in cash or by delivering or issuing another financial instrument — These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments, (for example, a mortgage that is paid out in instalments in line with the progress of construction).

RECOGNITION

.09 A contract establishing a financial instrument creates, at its inception, rights and obligations to receive or deliver economic benefits. The financial assets and **financial liabilities** portray these rights and obligations in financial statements. The assessment of those benefits is a measurement question and does not affect the timing of **recognition**. Recognition occurs when a government becomes a party to a financial instrument or non-financial derivative contract.

.10 From inception, derivative financial instruments give one party the contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. Derivatives create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument (see paragraph A17).

.11 ➤ *A government should recognize a financial asset or a financial liability on its statement of financial position when, and only when, a government becomes a party to the contractual provisions of the instrument.*

.12 Contracts may contain provisions that cause certain of its future cash flows to vary in response to changes in a rate, price, index of prices or rates, credit index or other variable in a way similar to a stand-alone derivative. In support of the objectives of financial reporting, a derivative embedded in a host contract is evaluated for recognition.

.13 Not all contracts containing provisions with the features of an embedded derivative will warrant the recognition of the embedded derivative and

measurement of its value. Generally, this is only necessary when contractual provisions with the characteristics of a derivative are not closely related to the economic characteristics and risks of the contract itself. For example, an interest or principal payment indexed to the price of a commodity (such as oil) that is embedded in a debt instrument is not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

.14 ➤ *A government should identify contracts containing one or more embedded derivatives and apply paragraphs A18-A26 in determining if they are to be recognized.*

MEASUREMENT

Measurement categories

.15 All items within the scope of this Section are assigned to one of two measurement categories:
(a) fair value**;** or
(b) cost or **amortized cost.**

Derivatives

.16 Governments generally enter into derivatives for risk management purposes. One of the defining characteristics of a derivative is that it has an initial net investment smaller than required for other types of contracts expected to have a similar response to changes in market factors. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.

.17 By their nature, derivatives exhibit highly variable cash flows. Fair value is the only relevant basis for their measurement because the historical cost of a derivative is at most a nominal value. Fair value depicts the market's assessment of the present value of the net future cash flows directly or indirectly embodied in a derivative contract, discounted to reflect both current interest rates and the market's assessment of the risk that the cash flows will not occur. Fair value reflects a current cash equivalent rather than the price of a past transaction.

Equity instruments

.18 As equity instruments represent a residual ownership interest, information about their cost is of limited usefulness, particularly when they are held over an extended period. When equity instruments that are quoted in an active market are portfolio investments, their market value provides a readily available and reliable measure of value at the financial statement date.

.19 An equity instrument is regarded as quoted in an active market when quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices reflect actual and regularly occurring market transactions on an arm's length basis.

Fair value

.20 ➤ *A government should include the following items in the fair value category:*
(a) derivatives; and
(b) portfolio investments in equity instruments that are quoted in an active market.

.21 Apart from items such as derivatives and equity instruments, the cash flows of a large portion of the financial instruments held by governments are fixed or slightly variable. The incremental benefit of fair value measurement for such items is often limited and may be outweighed by cost constraints. When financial assets are not reported at fair value, a periodic impairment assessment is needed to ensure representational faithfulness is not diminished.

.22 When governments manage and report performance for groups of financial assets, financial liabilities or both on a fair value basis, they may wish to report these items on this basis in their financial statements. Also, when reporting on a contract with the features of a derivative embedded in its terms (a contract with an "embedded derivative"), a government may determine that it is practical to designate the entire contract for fair value measurement rather than separately accounting for its derivative features. In each case, measuring items at fair value is seen to enhance the decision usefulness of the information provided to those using financial statements. For these reasons, the option to measure these items at fair value is provided.

.23 ➤ *A government that defines and implements a risk management or investment strategy to manage and evaluate the performance of a group of financial assets, financial liabilities or both on a fair value basis, may include those items that are within the scope of this Section in the fair value category.*

.24 Classification of a group of financial assets, financial liabilities or both to the fair value category is an accounting policy decision. A government defines and discloses the characteristics of financial instruments in the class and discloses this information in accordance with DISCLOSURE OF ACCOUNTING POLICIES, Section PS 2100. The policy determines the categorization of financial assets and financial liabilities upon their initial recognition.

.25 ➤ *Portfolio investments in equity instruments that do not have a quoted market price in an active market, and derivatives that are linked to and must be settled by delivery of such unquoted equity investments, should be measured at cost.*

.26 ➤ *A government may designate a contract to be a financial instrument carried at fair value if it contains one or more embedded derivatives unless:*
(a) the embedded derivative(s) do not significantly modify the cash flows that otherwise would be required by the contract; or
(b) separation of the embedded derivative(s) is prohibited when applying paragraphs A18-A26.

Fair value measurement considerations

.27 ➤ *A government should apply paragraphs A27-A40 in measuring financial instruments in the fair value category.*

.28 The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, a government establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, a government uses that technique. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on inputs specific to that government. It incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments. Periodically, a government calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on any available observable market data.

.29 The fair value of a financial liability with a demand feature (for example, a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

Transaction costs

.30 Transaction costs are incremental costs directly attributable to the acquisition or issue of a financial asset or a financial liability. An incremental cost is one that would not have been incurred if a government had not acquired or issued the financial instrument.

.31 Transaction costs are added to the carrying value of items in the cost or amortized cost category when they are initially recognized. However, when items in the fair value category are initially recognized, transaction costs are expensed. If transaction costs were added, the initial carrying amount would exceed fair value. This would be inconsistent with the measurement of other items within the category.

.32 Transaction costs include fees and commissions paid to agents, advisors, brokers and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Effective interest method

.33 ➤ *A government should measure interest using the **effective interest method**.*

Impairment of financial assets

.34 At each financial statement date, a government assesses financial assets or groups of financial assets to determine whether there is any objective evidence of impairment. If any such evidence exists, a government would apply:

(a) PORTFOLIO INVESTMENTS, Section PS 3040, to assess whether portfolio investments are impaired and to account for any such impairment; or

(b) LOANS RECEIVABLE, Section PS 3050, to assess whether loans receivable are impaired and to account for any such impairment.

.35 The requirement to assess financial assets for impairment includes non-derivative financial assets in the fair value category. Impairment charges are indicative of a loss in value that reflects the expectation that the underlying economic resource has diminished in a manner that is other than temporary.

.36 ➤ *Changes in valuation allowances and impairment losses (such as write-downs of portfolio investments, write-offs of loan receivables, etc.) are expenses and are not reported as remeasurement gains and losses.*

Reclassification

.37 When a quoted price in an active market is no longer available for an equity instrument that is a portfolio investment, it is reclassified. The most recent value at which the equity instrument traded becomes its new cost. At each financial statement date, a government assesses its financial assets for any objective evidence of impairment.

.38 ➤ *When a quoted price in an active market is no longer available for an equity instrument that is a portfolio investment, a government should measure the portfolio investment at cost. The most recent quoted price becomes its new cost.*

.39 When a quoted price in an active market becomes available for an equity instrument that is a portfolio investment for which such a price previously was not available, it is reclassified into the fair value category. The full amount of any change in its value is reported as a remeasurement gain or loss in the period of reclassification.

.40 ➤ *When a quoted price in an active market becomes available for an equity instrument that is a portfolio investment for which such a price previously was not available, the asset should be remeasured at fair value and the difference between its carrying value and fair value is reported as a remeasurement gain or loss.*

.41 The classification of financial instruments is determined upon their initial recognition. Paragraphs .38 and .40 also apply to financial assets and financial liabilities included in the fair value category in accordance with the provisions of paragraph .23. Financial assets and financial liabilities are not reclassified for other reasons.

DERECOGNITION OF A FINANCIAL LIABILITY

.42 ➤ *A government should remove a financial liability (or part of a financial liability) from its statement of financial position when, and only when, it is extinguished (i.e., when the obligation specified in the contract is discharged or cancelled, or expires).*

.43 A financial liability (or part of a financial liability) is extinguished when the debtor either:

(a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or

(b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (When the debtor has given a guarantee, this condition may still be met.)

.44 If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term. A market maker facilitates market operations by standing ready to buy and sell a particular instrument. However, irrespective of the role or intent of a government, repurchases of its own securities are accounted for as an extinguishment.

.45 Payment to a third party, including a trust (sometimes called "in-substance defeasance"), does not, by itself, relieve the debtor of its primary obligation to the creditor in the absence of legal release.

.46 If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognize the debt obligation, unless the condition in paragraph .43(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to the original creditor, the debtor recognizes a new debt obligation to the third party.

.47 ➤ *An exchange between an existing borrower and lender of debt instruments with substantially different terms should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or part of it (whether or not attributable to the financial difficulty of the debtor) should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.*

.48 For the purpose of paragraph .47, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 percent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognized as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortized over the remaining term of the modified liability.

.49 ➤ *The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, should be recognized as a revenue or expense and not as a remeasurement gain or loss.*

.50 ➤ *If a government repurchases a part of a financial liability, it should allocate the previous carrying amount of the financial liability between the part that continues to be recognized and the part that is derecognized based on the relative fair values of those parts on the date of the repurchase. The difference between the carrying amount allocated to the part derecognized and the consideration paid, including any non-cash assets transferred or liabilities*

assumed, for the part derecognized should be recognized as a revenue or expense and not as a remeasurement gain or loss.

PRESENTATION

Remeasurement gains and losses

.51 In presenting its statement of operations, a government distinguishes remeasurement gains and losses from those revenues and expenses that are not remeasurement gains and losses. This distinction is achieved as the statement of operations is divided into two components. The first component reports revenues (other than remeasurement gains) and expenses (other than remeasurement losses). Remeasurement gains and losses are reported as the second component, immediately below the first.

.52 ➤ *A change in the fair value of a financial instrument in the fair value category should be recognized and presented in the statement of operations as a remeasurement gain or loss.*

.53 By presenting remeasurement gains and losses separately, changes in the carrying value of financial instruments arising from fair value measurement are distinguished from other revenues and expenses. The first component reports the extent to which revenues raised in the period were sufficient to meet the expenses incurred. Remeasurement gains and losses attributable to financial instruments in the fair value category do not affect this assessment as they are presented as the second component of the statement of operations. Taken together, the two components report the extent to which a government has maintained its net assets in the period.

Interest, dividends, gains and losses

.54 Interest and dividends attributable to financial instruments are revenues and expenses and are not remeasurement gains or losses. Similarly, net settlements on derivative financial instruments attributable to the reporting period are revenues and expenses and are not remeasurement gains and losses.

.55 ➤ *When a financial instrument is derecognized, a gain or loss is recognized.*

.56 When a financial instrument in the fair value category is derecognized, the cumulative amount of remeasurement gains and losses previously reported is reversed and a gain or loss on disposal is recognized.

Offsetting of a financial asset and a financial liability

.57 ➤ *A financial asset and a financial liability should be offset and the net amount reported in the statement of financial position when, and only when, a government:*
(a) currently has a legally enforceable right to set off the recognized amounts; and
(b) intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

.58 Financial assets and financial liabilities are presented on a net basis when doing so reflects a government's expected future cash flows from settling two or more

separate financial instruments. When a government has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other consistent with their characteristics as resources or obligations of a government.

.59 Offsetting a recognized financial asset and a recognized financial liability and presenting the net amount differs from derecognition of a financial asset or a financial liability. Unlike derecognition, offsetting does not give rise to a gain or loss. When the conditions in paragraph .57 are satisfied, a government has, in effect, a single cash flow and a single financial asset or financial liability.

.60 A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor, provided there is an agreement between the three parties that clearly establishes the debtor's right of set-off. Because the right of set-off is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another, and the laws applicable to the relationships between the parties need to be considered.

.61 The existence of an enforceable right to set off a financial asset and a financial liability affects the rights and obligations associated with a financial asset and a financial liability and may affect a government's exposure to credit and **liquidity risk**. However, the existence of the right, by itself, is not a sufficient basis for offsetting. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of a government's future cash flows are not affected. When a government intends to exercise the right or to settle simultaneously, presentation of the asset and liability on a net basis reflects more appropriately the amounts and timing of the expected future cash flows, as well as the risks to which those cash flows are exposed. An intention by one or both parties to settle on a net basis without the legal right to do so is not sufficient to justify offsetting because the rights and obligations associated with the individual financial asset and financial liability remain unaltered.

.62 A government's intentions with respect to settlement of particular assets and liabilities may be influenced by its normal practices, the requirements of the financial markets, and other circumstances that may limit the ability to settle net or to settle simultaneously. When a government has a right of set-off, but does not intend to settle net or to realize the asset and settle the liability simultaneously, the effect of the right on its **credit risk** exposure is disclosed in accordance with paragraph .88.

.63 Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organized financial market or a face-to-face exchange. In these circumstances the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk. In other circumstances, a government may settle two instruments by receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. Such risk exposures may be significant even though relatively brief. Accordingly, realization of a financial asset and settlement of a financial liability are treated as simultaneous only when the transactions occur at the same moment.

.64 The conditions set out in paragraph .57 are generally not satisfied and offsetting is usually inappropriate when:

(a) several different financial instruments are used to emulate the features of a single financial instrument (a "synthetic instrument");

(b) financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counterparties;

(c) financial or other assets are pledged as collateral for non-recourse financial liabilities;

(d) financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for example, a sinking fund arrangement); or

(e) obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance contract.

.65 A government that undertakes a number of financial instrument transactions with a single counterparty may enter into a "master netting arrangement" with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract. These arrangements are commonly used by financial institutions to provide protection against loss in the event of bankruptcy or other circumstances that result in a counterparty being unable to meet its obligations. A master netting arrangement commonly creates a right of set-off that becomes enforceable and affects the realization or settlement of individual financial assets and financial liabilities only following a specified event of default or in other circumstances not expected to arise in the normal course of operations. A master netting arrangement does not provide a basis for offsetting, unless both of the criteria in paragraph .57 are satisfied. When financial assets and financial liabilities subject to a master netting arrangement are not offset, the effect of the arrangement on a government's exposure to credit risk is disclosed in accordance with paragraph .88.

FINANCIAL STATEMENT DISCLOSURES

Classes of financial instruments and level of disclosure

.66 When this Section requires disclosures by class of financial instrument, a government groups financial instruments into classes that are appropriate to the nature of the information disclosed and that takes into account the characteristics of those financial instruments. A government provides sufficient information to permit reconciliation to the line items presented in the statement of financial position.

Significance of financial instruments for financial position and changes in financial position

.67 ➤ *A government should disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and changes in its financial position.*

Statement of financial position

.68 The carrying amounts of financial assets of each of the following categories are disclosed either in the statement of financial position or in the notes:
(a) cost or amortized cost;
(b) fair value, showing separately:
(i) derivatives;
(ii) portfolio investments in equity instruments that are quoted in an active market; and
(iii) financial assets designated to the fair value category.

.69 The carrying amounts of financial liabilities of each of the following categories are disclosed either in the statement of financial position or in the notes:
(a) cost or amortized cost;
(b) fair value, showing separately:
(i) derivatives; and
(ii) financial liabilities designated to the fair value category.

.70 If at the financial statement date, a government holds items that it has designated to the fair value category, it provides the disclosures in paragraphs A51-A54.

Collateral

.71 A government discloses:
(a) the carrying value of financial assets it has pledged as collateral for liabilities or contingent liabilities; and
(b) the terms and conditions relating to its pledge.

Defaults and breaches

.72 For loans payable recognized at the financial statement date, a government discloses:
(a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;
(b) the carrying amount of the loans payable in default at the end of the reporting period; and
(c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the date the financial statements were completed.

.73 If, during the period, there were breaches of loan agreement terms other than those described in paragraph .72, a government discloses the same information as required by paragraph .72 if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the financial statement date).

Statement of operations — remeasurement gains and losses

.74 A government discloses remeasurement gains and losses, distinguishing between:
(a) amounts arising during the period; and
(b) the reclassification of remeasurement gains and losses reported in previous periods to revenues (other than remeasurement gains) and expenses (other than remeasurement losses).

.75 Remeasurement gains and losses are presented in a manner that informs readers as to their origins by distinguishing among:
(a) derivatives;
(b) portfolio investments in equity instruments that are quoted in an active market; and
(c) financial instruments designated to the fair value category.

Other disclosures

.76 In accordance with DISCLOSURE OF ACCOUNTING POLICIES, Section PS 2100, a government discloses the measurement basis (or bases) used in preparing the financial statements and other accounting policies that are relevant to an understanding of the financial statements.

.77 A government holding derivatives discloses information to explain the purpose of those derivative holdings. It provides information to explain how derivatives entered into during the period and held at the financial statement date support management of the nature and extent of risks arising from financial instruments disclosed in accordance with the requirements of paragraphs .83-.94.

.78 A government holding derivatives or items it has designated to the fair value category at the financial statement date discloses the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities. For example, if applicable, a government discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates. If there has been a change in valuation technique, a government discloses that change and the reasons for making it.

.79 To make the disclosures required in paragraph .80, a government classifies fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy used has the following levels:
(a) quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1);
(b) inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices) (Level 2); and
(c) inputs for the asset or liability that are not based on observable market data (unobservable inputs) (Level 3).

When measurement of an item requires the use of inputs from more than one level, the measurement level attributable is determined on the basis of the lowest level input that is significant to the fair value measurement in its entirety. For this purpose, the significance of an input is assessed against the fair value measurement in its entirety. If a fair value measurement uses observable inputs that require significant adjustment based on unobservable inputs, that measurement is a Level 3 measurement. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

.80 For fair value measurements recognized in the statement of financial position, a government discloses the following for each class of financial instruments.

(a) The level in the fair value hierarchy into which the fair value measurements are categorized in their entirety, segregating fair value measurements in accordance with the levels defined in paragraph .79.
(b) Any significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers. Transfers into each level are disclosed and discussed separately from transfers out of each level. For this purpose, significance is judged with respect to remeasurement gains and losses and total financial assets or total liabilities.
(c) For fair value measurements in Level 3 of the fair value hierarchy, a reconciliation from the beginning balances to the ending balances, disclosing separately changes during the period attributable to the following:
    (i) total gains or losses for the period recognized in remeasurement gains and losses;
    (ii) purchases, sales, issues and settlements (each type of movement disclosed separately); and
    (iii) transfers in or out of Level 3 (for example, transfers attributable to changes in the observability of market data) and the reasons for those transfers; and
(d) for fair value measurements in Level 3, if changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly, a government states that fact and discloses the effect of those changes.

In the case of significant transfers in or out of Level 3, transfers into Level 3 are disclosed and discussed separately from transfers out of Level 3. A government discloses how the effect of a change to a reasonably possible alternative assumption was calculated. In these cases, significance is judged with respect to remeasurement gains and losses and total financial assets or total liabilities.

.81 If the market for a financial instrument is not active, a government establishes its fair value using a valuation technique (see paragraphs A33-A39). Nevertheless, the best evidence of fair value at initial recognition is the transaction price (i.e., the fair value of the consideration given or received), unless conditions described in paragraph A35 are met. It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique. If such a difference exists, a government discloses, by class of financial instrument:
(a) its accounting policy for reporting that difference in remeasurement gains and losses to reflect a change in factors (including time) that market participants would consider in setting a price (see paragraph A36); and
(b) the aggregate difference yet to be reported in remeasurement gains and losses at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

.82 Disclosures of fair value are not required:
(a) for financial assets, other than portfolio investments, reported at amortized cost;
(b) for financial liabilities reported at amortized cost; and
(c) for portfolio investments in equity instruments that do not have a quoted price in an active market, and derivatives that are linked to and must be settled by such unquoted equity instruments that are measured at cost in accordance with this Section because its fair value cannot be measured reliably.

RISK DISCLOSURES

Nature and extent of risks arising from financial instruments

.83 ➤ *A government should disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which it is exposed at the financial statement date.*

.84 The required disclosures focus on the risks that arise from financial instruments and how they have been managed. These risks typically include credit risk, liquidity risk and **market risk**. Market risk comprises three types of risk: **currency risk**, **interest rate risk** and **other price risk**. Disclosures assist users in understanding the nature and extent of these risks. The disclosures required in paragraphs .85-.94 are provided in the notes to the financial statements. Alternatively, the disclosures may appear within a financial statement discussion and analysis that is an integral part of and cross-referenced to a government's financial statements.

Qualitative disclosures

.85 For each type of risk arising from financial instruments, a government discloses:
(a) the exposures to risk and how they arise;
(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and
(c) any changes in (a) or (b) from the previous period.

Quantitative disclosures

.86 For each type of risk arising from financial instruments, a government discloses:
(a) summary quantitative data about its exposure to that risk at the financial statement date;
(b) the disclosures required by paragraphs .88-.94 to the extent not provided in (a), unless the risk is not material (see FINANCIAL STATEMENT PRESENTATION, paragraph PS 1200.015); and
(c) concentrations of risk if not apparent from (a) and (b).
The disclosure relating to summary quantitative data is based on the information provided internally to key management personnel (for example, the government's deputy minister of finance or chief financial officer).

.87 If the quantitative data disclosed as at the financial statement date are unrepresentative of a government's exposure to risk during the period, a government provides further information that is representative.

Credit risk

.88 A government discloses by class of financial instrument:
(a) the amount that best represents its maximum exposure to credit risk at the financial statement date without taking account of any collateral held or other credit enhancements (for example, netting agreements that do not qualify for offset in accordance with paragraph .57;
(b) in respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancements;
(c) information about the credit quality of financial assets that are neither past due nor impaired; and

(d) the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

Financial assets that are either past due or impaired

.89 A government discloses by class of financial asset:
(a) an analysis of the age of financial assets that are past due as at the financial statement date but not impaired;
(b) an analysis of financial assets that are individually determined to be impaired as at the financial statement date, including the factors the government considered in determining that they are impaired;
(c) information (both positive and negative) considered in reaching the conclusion that the financial asset or the grouping of financial assets is not impaired; and
(d) for the amounts disclosed in (a), (b), and (c), a description of collateral held by it as security and other credit enhancements and, unless impracticable, an estimate of their fair value.

Collateral and other credit enhancements obtained

.90 When a government obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (for example, guarantees), and such assets meet the recognition criteria (see FINANCIAL STATEMENT CONCEPTS, Section PS 1000), a government discloses:
(a) the nature and carrying amount of the assets obtained; and
(b) when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

Liquidity risk

.91 A government discloses:
(a) a maturity analysis for non-derivative financial liabilities that shows the remaining contractual maturities;
(b) a maturity analysis for derivative financial liabilities; and
(c) a description of how it manages the liquidity risk inherent in (a) and (b).
The maturity analysis in (b) includes the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of cash flows.

Market risk

.92 Unless a government complies with paragraph .93, it discloses:
(a) a sensitivity analysis for each type of market risk to which it is exposed at the financial statement date, showing how revenues and expenses for the period would have been affected by changes in the relevant risk variable that were reasonably possible at that date;
(b) the methods and assumptions used in preparing the sensitivity analysis; and
(c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.

.93 If a government prepares a sensitivity analysis, such as value at risk, that reflects interdependencies between risk variables (for example, interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity

analysis in place of the analysis specified in paragraph .92. A government also discloses:

(a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and

(b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

Other market risk disclosures

.94 When the sensitivity analyses disclosed in accordance with paragraphs .92-.93 are unrepresentative of a risk inherent in a financial instrument (for example, because the exposure at the financial statement date does not reflect the exposure during the year), a government would disclose that fact and the reason it believes the sensitivity analyses are unrepresentative.

TRANSITIONAL PROVISIONS

.95 This Section applies to fiscal years beginning on or after April 1, 2012. Earlier adoption is encouraged.

.96 The transition to this Section is as follows:

(a) Recognition, derecognition and measurement policies followed in financial statements for periods prior to the effective date of this Section are not reversed and, therefore, those financial statements are not restated. When transitioning to this Section, a government discloses that the financial statements of prior periods, including comparative information, have not been restated.

(b) At the beginning of the fiscal year in which this Section is initially applied, a government:

(i) recognizes all financial assets and financial liabilities on its statement of financial position and classifies items in accordance with paragraph .57;

(ii) applies the criteria in paragraphs .20 and .23 in identifying those financial assets and financial liabilities to be measured at fair value; and

(ii) remeasures assets and liabilities as appropriate. Any adjustment of the previous carrying amount is recognized as an adjustment to accumulated surplus/deficit at the beginning of the fiscal year in which this Section is initially applied.

(c) A government establishes an accounting policy that applies to the identification of embedded derivatives in contracts entered into by it. The policy and its application ensures that the financial statements as at the transition date recognize as separate assets and liabilities those embedded derivatives required to be reported in accordance with provisions of this Section. The government discloses the accounting policy and any adjustment to accumulated surplus/deficit at the beginning of the fiscal period in which this Section is initially applied.

GLOSSARY

Amortized cost is the amount at which a financial asset or a financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

Derecognition is the removal of previously recognized financial assets or financial liabilities from a government's statement of financial position.

Derivatives are financial instruments or other contracts within the scope of this Section (see paragraphs .03-.08) with all three of the following characteristics:
(a) their value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the "underlying");
(b) they require no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
(c) they are settled at a future date(s).

The **effective interest method** is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability (see also paragraphs A41-A45).

Equity instruments are any contracts that evidence a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value is the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

Financial assets are assets that could be used to discharge existing liabilities or finance future operations and are not for consumption in the normal course of operations.

Financial instruments are any contracts that give rise to financial assets of one entity and financial liabilities or equity instruments of another entity.

Financial liabilities are any liabilities that are contractual obligations:
(a) to deliver cash or another financial asset to another entity; or
(b) to exchange financial instruments with another entity under conditions that are potentially unfavourable to a government.

Financial risks involve credit risk, currency risk, interest rate risk, liquidity risk, market risk and other price risk, defined as follows:

> **Credit risk** is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
>
> **Currency risk** is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
>
> **Interest rate risk** is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
>
> **Liquidity risk** is the risk that a government will encounter difficulty in meeting obligations associated with financial liabilities.
>
> **Market risk** is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.
>
> **Other price risk** is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

Recognition is the process of including an item in the financial statements. It means inclusion of an item within one or more individual statements and does not mean disclosure in the notes to the financial statements.

Remeasurement gains and losses are revenues and expenses that arise when financial instruments in the fair value category are remeasured in accordance with the requirements of this Section.

APPENDIX

APPLYING THE REQUIREMENTS

This Appendix is an integral part of this Section.

TABLE OF CONTENTS

PURPOSE AND SCOPE

A1 Governments are not themselves issuers of equity instruments. However, they may hold equity instruments issued by others for their own account. The requirements of this Section apply when accounting for an investment in equity instruments held by a government that is not a controlling interest.

A2 In general, insurance contracts held or issued by a government are excluded from the requirements of this Section. This exclusion does not extend to freestanding derivative instruments but excludes contracts under which one entity (the insurer) accepts significant insurance risk from another entity (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

A3 Contracts that require a payment based on climatic, geological or other physical variables are commonly used as insurance policies. (Those based on climatic variables are sometimes referred to as weather derivatives.) In such cases,

the payment is based on the amount of loss to the insured entity. Rights and obligations under insurance contracts are excluded from the scope of this Section by paragraph .03(k). The payout under some contracts that require a payment based on climatic, geological or other physical variables is unrelated to the amount of an insured government's loss. Such contracts are excluded from the scope of this Section by paragraph .03(l) unless they are traded on an exchange. A contract based only partially on climatic geological or other physical variables may contain an embedded derivative. For example, when an interest rate swap is contingent on a climatic variable, such as heating degree days, the interest rate swap element is an embedded derivative that is within the scope of this Section.

DEFINITIONS

Financial instrument

A4 Currency (cash) is a financial asset because it represents the medium of exchange and, therefore, is the basis on which all transactions are measured and recognized in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.

A5 Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:
(a) accounts receivable and payable;
(b) notes receivable and payable;
(c) loans receivable and payable; and
(d) bonds receivable and payable.
In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive).

A6 A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument. A chain of contractual rights or contractual obligations meets the definition of a financial instrument if it will ultimately lead to the receipt or payment of cash or to the acquisition of an equity instrument.

A7 The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognized in the financial statements. Some of these contingent rights and obligations may be insurance contracts.

A8 Physical assets (such as inventories of supplies, tangible capital assets), and leased assets are not financial assets. Control of such assets creates an opportunity to produce or supply goods and services, rent to others, use for administrative purposes or for the development, construction or repair of other tangible capital assets. Control of such assets does not give rise to a present right to receive cash or another financial asset.

A9 Assets, such as prepaid expenses, for which the future economic benefit is the receipt of goods or services rather than the right to receive cash or another financial asset, are not financial assets. Similarly, certain deferred liabilities are not financial liabilities when the outflow of economic benefits associated with them is in the nature of goods or services rather than a contractual obligation to pay cash or another financial asset.

Derivative financial instruments

A10 Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. However, they generally do not result in a transfer of the underlying primary financial instrument on inception of the contract, nor does such a transfer necessarily take place on maturity of the contract.[1] Some instruments embody both a right and an obligation to make an exchange. Because the terms of the exchange are determined on inception of the derivative instrument, as prices in financial markets change those terms may become either favourable or unfavourable.

A11 A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume, or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionately with a change in the underlying item) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of $1,000 if the six-month London Interbank Offered Rate (LIBOR) increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.

A12 One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.

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[1] This is true of most, but not all derivatives. For example, in some cross-currency interest rate swaps, principal is exchanged on inception (and re-exchanged on maturity).

Contracts to buy or sell non-financial items

A13 Contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. For example, contracts that provide for settlement only by the receipt or delivery of a non-financial item (such as an option, futures or forward contract on oil) are not financial instruments. Many commodity contracts are of this type. Some are standardized in form and traded on organized markets in much the same fashion as some derivative financial instruments. For example, a commodity futures contract may be bought and sold readily for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the underlying commodity. The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do not alter the fundamental character of the contract in a way that creates a financial instrument. Nevertheless, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of this Section as if they were financial instruments (see paragraph .05).

A14 A contract that involves the receipt or delivery of physical assets does not give rise to a financial asset of one party and a financial liability of the other party, unless any corresponding payment is deferred past the date on which the physical assets are transferred. Such is the case with the purchase or sale of goods on trade credit.

RECOGNITION

Traded securities — use of "trade-date" accounting

A15 The purchase or sale of financial assets traded on a recognized exchange (a regular-way purchase or sale) gives rise to a fixed-price commitment between the trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment, it is not recognized as a derivative financial instrument.

A16 When a government purchases or sells an asset through a recognized exchange or securities market it:

(a) recognizes the asset to be received and the liability to pay for it on the trade date; and

(b) derecognizes the asset that is sold, recognizing any gain or loss on its disposal, and recognizes a receivable from the buyer for payment on the trade date.

In general, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.

Derivatives

A17 As a consequence of the principle in paragraph .11, a government recognizes all of its contractual rights and obligations under derivatives on its statement of financial position as assets and liabilities. The following are examples of applying this principle.

(a) Unconditional receivables and payables are recognized as assets or liabilities when a government becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.

(b) Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognized until at least one of the parties has performed under the agreement. For example, a government ordering goods does not generally recognize a liability at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this Section, its net fair value is recognized as an asset or liability on the commitment date (see (c) below).

(c) A forward contract that is within the scope of this Section is recognized as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When a government becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognized as an asset or liability.

(d) Option contracts that are within the scope of this Section are recognized as assets or liabilities when the holder or writer becomes a party to the contract.

(e) Planned future transactions, no matter how likely, are not assets and liabilities because a government has not become a party to a contract.

Embedded derivatives

A18 An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract — with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

A19 An embedded derivative is separated from the host contract and accounted for as a derivative if, and only if, all of the following conditions are met:

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid (combined) instrument is not measured at fair value (i.e., derivatives embedded in financial instruments in the fair value category are not separated).

A20 If an embedded derivative is separated, the host contract would be accounted for applying the provisions in this Section if it is a financial instrument, and in accordance with other appropriate standards if it is not a financial instrument.

A21 A government assesses whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when a government first becomes a party to the contract. Subsequent reassessment is prohibited, unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract. A government determines whether a modification to cash flows is significant by considering the extent to which the expected cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

A22 If a contract contains one or more embedded derivatives, a government may designate the entire hybrid (combined) contract as a financial instrument carried at fair value (paragraph .26). This designation is irrevocable.

A23 If a government is required to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at a subsequent reporting date, it would treat the entire hybrid (combined) contract as a financial instrument carried at fair value.

A24 An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.

A25 The economic characteristics and risks of an embedded derivative are not closely related to the host contract (see paragraph A20(a)) in the following examples. In these examples, assuming the conditions in paragraph A19(b)-(c) are met, a government accounts for the embedded derivative separately from the host contract.

(a) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension.

(b) Equity-indexed interest or principal payments embedded in a host debt instrument — by which the amount of interest or principal is indexed to the value of equity instruments — are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

(c) Commodity-indexed interest or principal payments embedded in a host debt instrument — by which the amount of interest or principal is indexed to the price of a commodity (such as oil) — are not closely related to the

host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

(d) A call, put, or prepayment option embedded in a host debt contract is not closely related to the host contract unless the option's exercise price is approximately equal on each exercise date to the amortized cost of the host debt instrument.

(e) Credit derivatives that are embedded in a host debt instrument and allow one party (the beneficiary) to transfer the credit risk of a particular reference asset, which it may not own, to another party (the guarantor) are not closely related to the host debt instrument. Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.

A26 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, a government does not account for the embedded derivative separately from the host contract.

(a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract is closely related to the host contract unless the combined instrument can be settled in such a way that the holder would not recover substantially all of its recognized investment, or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.

(b) An embedded floor or cap on the interest rate on a debt contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (for example, a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.

(c) An embedded foreign currency derivative in a host contract that is not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract, provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(i) the functional currency of any substantial party to that contract;

(ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

(iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (for example, a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

(d) An embedded prepayment option in an interest-only or principal-only strip is closely related to the host contract provided the host contract:

(i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative; and
(ii) does not contain any terms not present in the original host debt contract.

(e) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is:
(i) an inflation-related index such as an index of lease payments to a consumer price index, provided the lease is not leveraged and the index relates to inflation in the entity's own economic environment);
(ii) contingent rentals based on related sales; or
(iii) contingent rentals based on variable interest rates.

MEASUREMENT

Fair value measurement considerations

A27 For financial instruments in the fair value category, the provisions in paragraphs A28-A40 explain the application of fair value measurement including the use of valuation techniques. Valuation techniques may be required to measure some derivatives and when a quoted market price is not available for financial assets or financial liabilities that are designated by a government to the fair value category.

A28 Underlying the definition of fair value is a presumption that a government is a going concern without any intention or need to liquidate or undertake a transaction on adverse terms. Fair value is not, therefore, the amount that a government would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument.

A29 This Section uses the terms "bid price" and "asking price" (sometimes referred to as "current offer price") in the context of quoted market prices, and the term "the bid-ask spread" to include only transaction costs. Other adjustments to arrive at fair value (for example, for counterparty credit risk) are not included in the term "bid-ask spread".

Active market — quoted price

A30 A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. Fair value is defined in terms of a price agreed by a willing buyer and a willing seller in an arm's length transaction. The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the end of the period in that instrument (i.e., without modifying or repackaging the instrument) in the most advantageous active market to which a government has immediate access. However, a government adjusts the price in the more advantageous market to reflect any differences in counterparty credit risk between instruments traded in that market and the one being valued. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability.

A31 The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. When a government has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (for example, a change in the risk-free interest rate following the most recent price quote for a corporate bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate. Similarly, if a government can demonstrate that the last transaction price is not fair value (for example, because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

A32 If a rate (rather than a price) is quoted in an active market, a government uses that market-quoted rate as an input into a valuation technique to determine fair value. If the market-quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, a government adjusts for those factors.

No active market — valuation technique

A33 If the market for a financial instrument is not active, a government establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, a government uses that technique.

A34 The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value when:

(a) it reasonably reflects how the market could be expected to price the instrument; and

(b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.

A35 Therefore, a valuation technique:

(a) incorporates all factors that market participants would consider in setting a price; and

(b) is consistent with accepted economic methodologies for pricing financial instruments.

Periodically, a government calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on any available observable market data. A government obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (i.e., the fair value of the consideration given or received), unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.

A36 The application of paragraph A35 may result in no gain or loss being recognized on the initial recognition of a financial asset or a financial liability. In such a case, the financial asset or financial liability is subsequently measured, and gains and losses are subsequently recognized, in accordance with this Section. Accordingly, a gain or loss is recognized after initial recognition only to the extent that it arises from a change in a factor that market participants would consider in setting a price.

A37 The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a loan), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by a government or by others for similar debt instruments (for example, similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis). Alternatively, provided there is no change in the credit risk of the debtor and applicable credit spreads after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date. When conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, adjusted as appropriate, for any differences from the instrument being valued.

A38 The same information may not be available at each measurement date. For example, at the date that a government makes a loan or acquires a debt instrument that is not actively traded, it has a transaction price that is also a market price. However, no new transaction information may be available at the next measurement date and, although a government can determine the general level of market interest rates, it may not know what level of credit or other risk market participants would consider in pricing the instrument on that date. A government may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining

a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. However, a government would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, a government would consider the effects of the change in determining the fair value of the financial instrument.

A39 In applying discounted cash flow analysis, a government uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made.

Inputs to valuation techniques

A40 An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial instrument will be based on one or more of the following factors (and perhaps others).

(a) The time value of money (i.e., interest at the basic or risk-free rate) — Basic interest rates can usually be derived from observable government bond prices and are often quoted in financial publications. These rates typically vary with the expected dates of the projected cash flows along a yield curve of interest rates for different time horizons. For practical reasons, a government may use a well-accepted and readily observable general rate, such as LIBOR or a swap rate, as the benchmark rate. (Because a rate such as LIBOR is not the risk-free interest rate, the credit risk adjustment appropriate to the particular financial instrument is determined on the basis of its credit risk in relation to the credit risk in this benchmark rate.)

(b) Credit risk — The effect on fair value of credit risk (i.e., the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings.

(c) Foreign currency exchange prices — Active currency exchange markets exist for most major currencies, and prices are quoted daily in financial publications.

(d) Commodity prices — There are observable market prices for many commodities.

(e) Equity prices — Prices (and indexes of prices) of traded equity instruments are readily observable.

(f) Volatility (i.e., magnitude of future changes in price of the financial instrument or other item) — Measures of the volatility of actively traded items can normally be reasonably estimated on the basis of historical market data or by using volatilities implied in current market prices.

(g) Prepayment risk and surrender risk — Expected prepayment patterns for financial assets and expected surrender patterns for financial liabilities can be estimated on the basis of historical data. (The fair value of a financial liability that can be surrendered by the counterparty cannot be less than the present value of the surrender amount — see paragraph .29.)

(h) Servicing costs for a financial asset or a financial liability — Costs of servicing can be estimated using comparisons with current fees charged by other market participants. If the costs of servicing a financial asset or a financial liability are significant and other market participants would face comparable costs, the issuer would consider them in determining the fair value of that financial asset or financial liability. It is likely that the fair value at inception of a contractual right to future fees equals the origination costs paid for them, unless future fees and related costs are out of line with market comparables.

Effective interest method

A41 When calculating the effective interest rate, a government would estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but would not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), a government would use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

A42 When applying the effective interest method, a government generally amortizes any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortization period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortized to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e., interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortized over the expected life of the instrument.

A43 In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Governments include such incurred credit losses in the estimated cash flows when computing the effective interest rate.

A44 For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognized initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments

normally has no significant effect on the carrying amount of the asset or liability.

A45 If a financial asset or a group of similar interest-bearing financial assets has been written down as a result of an impairment loss, interest income is thereafter recognized using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

PRESENTATION OF REMEASUREMENT GAINS AND LOSSES

A46 In the period a government derecognizes financial instruments in the fair value category upon which remeasurement gains and losses were reported in preceding periods, it reports an adjustment to reverse the cumulative remeasurement gain or loss within the component of the statement of operations that reports remeasurement gains and losses.

A47 For example, a government has a fiscal period end of December 31. On April 15, 20X1, it makes a portfolio investment in the stock of a publicly traded company listed on a major stock exchange. The purchase price, excluding the commissions it expensed, is $100,000. The closing quoted market price for the investment at December 31, 20X1 is $125,000. On October 31, 20X2 it sells the stock for proceeds of $115,000. The amounts included in the statement of operations are set out below.

Consolidated Statement of Operations

For the year ended December 31 ($ thousands)	20X2 Budget	20X2 Actual	20X1 Actual
Revenues			
Gain on portfolio investment	5	15	–
Expenses	–	–	–
Surplus/deficit excluding remeasurement gains and losses	5	15	–
Remeasurement gains and losses		(25)	25
Surplus/deficit		(10)	25

FINANCIAL STATEMENT DISCLOSURES

Classes of financial instruments and level of disclosure

A48 Paragraph .66 requires a government to group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. The classes described in paragraph .66 are determined by it and, thus, are distinct from the two categories of financial instruments specified this Section, which determine how financial instruments are measured and where changes in fair value are presented.

A49 At a minimum, in determining classes of financial instruments, a government:
(a) distinguishes instruments measured at cost or amortized cost from those measured at fair value; and

(b) treats as a separate class or classes those financial instruments outside the scope of this Section.

A50 A government decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this Section, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, a government does not obscure important information by including it among a large amount of insignificant detail. Similarly, a government does not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.

Disclosures that apply to items designated to the fair value category

A51 When a government has designated items as financial instruments to the fair value category, the disclosures in set out in paragraphs A52-A54 apply to items held at the financial statement date.

A52 If a government has designated a loan or receivable (or a group of loans or receivables) to the fair value category, it discloses:
(a) the maximum exposure to credit risk of the loan or receivable (or group of loans or receivables) at the financial statement date;
(b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk;
(c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:
(i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or
(ii) using an alternative method a government believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset; and
(d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

A53 If a government has designated a financial liability (or a group of financial liabilities) to the fair value category, it discloses:
(a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability determined either:
(i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or
(ii) using an alternative method a government believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability; and

(b) the difference between the financial liability's carrying amount and the amount a government would be contractually required to pay at maturity to the holder of the obligation.

Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature (i.e., the return on the contract is linked to the return on an identified asset or pool of assets), changes in market conditions include changes in the performance of the related asset(s).

A54 A government discloses:

(a) the methods used to comply with the requirements in paragraphs A52(c) and A53(a); and

(b) if a government believes that the disclosure it has given to comply with the requirements in paragraphs A52(c) and A53(a) does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.

RISK DISCLOSURES

Quantitative disclosures

A55 Paragraph .86(a) requires disclosures of summary quantitative data about a government's exposure to risks based on the information provided internally to a government's key management personnel. When a government uses several methods to manage a risk exposure, it would disclose information using the method or methods that provide the most relevant and reliable information. FINANCIAL STATEMENT CONCEPTS, Section PS 1000, addresses relevance and reliability.

A56 Paragraph .86(c) requires disclosures about concentrations of risk. Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions. The identification of concentrations of risk requires judgment taking into account the circumstances of a government. Disclosure of concentrations of risk would include:

(a) a description of how management determines concentrations;

(b) a description of the shared characteristic that identifies each concentration (for example, by counterparty, geographical area, currency or market); and

(c) the amount of the risk exposure associated with all financial instruments sharing that characteristic.

Maximum credit risk exposure

A57 Paragraph .88 requires disclosure of the amount that best represents a government's maximum exposure to credit risk. For a financial asset, this is typically the gross carrying amount, net of:

(a) any amounts offset in accordance with paragraph .57; and

(b) any impairment losses or changes in valuation allowances recognized in accordance with FINANCIAL STATEMENT PRESENTATION, paragraph PS 1200.049, PORTFOLIO INVESTMENTS, Section PS 3040, and LOANS RECEIVABLE, Section PS 3050.

A58 Activities conducted with entities outside of a government's reporting entity that give rise to credit risk and the associated maximum exposure to credit risk include, but are not limited to the following.

(a) Making loans and advances to borrowers and placing deposits with other entities. In these cases, the maximum exposure to credit risk is the carrying amount of the related financial assets.

(b) Entering into derivative contracts, (for example, foreign exchange contracts, interest rate swaps and credit derivatives). When the resulting asset is measured at fair value, the maximum exposure to credit risk at the financial statement date will equal the carrying amount.

(c) Granting loan guarantees. In this case, the maximum exposure to credit risk is the maximum amount a government could have to pay if the guarantee is called on, which may be significantly greater than the provision for loss on the loan guarantee.

(d) Making a loan commitment that is irrevocable over the life of the facility or is revocable only in response to a material adverse change. If a government cannot settle the loan commitment net in cash or another financial instrument, the maximum credit exposure is the full amount of the commitment. This is because it is uncertain whether the amount of any undrawn portion may be drawn upon in the future. This may be significantly greater than the amount recognized as a liability.

A59 In accordance with paragraph .91, a government discloses summary quantitative data about its exposure to liquidity risk on the basis of the information provided internally to key management personnel. A government explains how such data is determined. If the outflows of cash (or another financial asset) included in the data could either:

(a) occur significantly earlier than indicated in the data: or

(b) be for significantly different amounts from those indicated in the data (i.e., for a derivative that is included in the data on a net settlement basis but for which the counterparty has the option to require gross settlement);

a government states that fact and provides quantitative information that enables users of its financial statements to evaluate the extent of this risk, unless that information is included in the contractual maturity analyses required by paragraph .91(a) or (b).

Liquidity risk

A60 In preparing the maturity analyses required by paragraph .91, a government uses its judgment to determine an appropriate number of time bands. For example, a government might determine that the following time bands are appropriate:

(a) not later than six months;

(b) later than six months and not later than one year;

(c) later than one year and not later than five years; and

(d) later than five years.

A61 In complying with paragraph .91(a)-(b), a government does not separate an embedded derivative from a hybrid (combined) financial instrument. For such an instrument, a government applies paragraph .91(a).

A62 Paragraph .91(b) requires a government to disclose a quantitative maturity analysis for derivative financial liabilities that shows remaining contractual maturities if the contractual maturities are essential for an understanding of the

timing of cash flows. For example, this would be the case for an interest swap with a remaining maturity of five years in a cash flow hedge of a variable rate financial asset or liability.

A63 Paragraph .91(a)-(b) requires a government to disclose maturity analysis for financial liabilities that show the remaining contractual maturities for some financial liabilities. A government considers the following in preparing its disclosures:

(a) When a counterparty has a choice of when an amount is paid, the liability is allocated to the earliest period in which a government can be required to pay. For example, financial liabilities that a government can be required to pay on demand (for example, demand deposits) are included in the earliest time band.

(b) When a government is committed to make amounts available in instalments, each instalment is allocated to the earliest period in which a government can be required to pay. For example, when a bond is redeemable at the holder's option, repayment of the bond is allocated to the earliest period in which the bond could be redeemed.

A64 The contractual amounts disclosed in the maturity analyses as required by paragraph .91(a)-(b) are the contractual undiscounted cash flows, for example:

(a) gross finance lease obligations (before deducting finance charges);

(b) prices specified in forward agreements to purchase financial assets for cash;

(c) net amounts for pay-floating/receive-fixed interest rate swaps for which net cash flows are exchanged; and

(d) contractual amounts to be exchanged in a derivative financial instrument (for example, a currency swap) for which gross cash flows are exchanged.

Such undiscounted cash flows differ from the amount included in the statement of financial position because the amount in that statement is based on discounted cash flows. When the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at the financial statement date. For example, when the amount payable varies with changes in an index, the amount disclosed may be based on the level of the index at the end of the period.

A65 Paragraph .91(c) requires a government to describe how it manages the liquidity risk inherent in the items disclosed in the quantitative disclosures required in paragraph .91(a)-(b). A government discloses a maturity analysis of financial assets it holds for managing liquidity risk (for example, financial assets that are readily saleable or expected to generate cash inflows to meet cash outflows on financial liabilities), if that information is necessary to enable users of its financial statements to evaluate the nature and extent of liquidity risk.

A66 Other factors a government might consider in providing the disclosure required in paragraph .91(c) include, but are not limited to, whether a government:

(a) has committed borrowing facilities or lines of credit that it can access to meet liquidity needs;

(b) has very diverse funding sources;

(c) has significant concentrations of liquidity risk in either its assets or its funding sources;

(d) has internal control processes and contingency plans for managing liquidity risk;

(e) has instruments that include accelerated repayment terms (for example, as might arise on the downgrade of a government's credit rating);

(f) has instruments that could require the posting of collateral (for example, margin calls for derivatives); and
(g) has instruments that are subject to master netting agreements.

Market risk

A67 Paragraph .92 requires a sensitivity analysis for each type of market risk to which a government is exposed. In accordance with paragraph A51, a government decides how it aggregates information to display the overall picture without combining information with different characteristics about exposures to risks from significantly different economic environments. Some examples are given below:
(a) A government that designates financial instruments to the fair value category that would otherwise be measured at amortized cost might disclose this information separately for financial instruments in the fair value category and those reported at cost or amortized cost.
(b) A government would not aggregate its exposure to market risks from within Canada with its exposure to the same market risks arising in foreign countries.
If a government has exposure to only one type of market risk in only one economic environment, it would not show disaggregated information.

A68 Paragraph .92(a) requires the sensitivity analysis to show the effect on revenues and expenses for the period of reasonably possible changes in the relevant risk variable (for example, prevailing market interest rates, currency rates, equity prices or commodity prices). In applying this requirement, a government evaluates these considerations.
(a) Governments are not required to determine what the operating results would have been if relevant risk variables had been different. Instead, governments disclose the effect on revenues or expenses (distinguishing remeasurement gains and losses, when necessary) assuming that a reasonably possible change in the relevant risk variable had occurred at the financial statement date and had been applied to the risk exposures in existence at that date. For example, if a government has a floating rate liability at the end of the year, a government would disclose the effect on interest expense for the current year if interest rates had varied by reasonably possible amounts.
(b) Governments are not required to disclose the effect on revenues or expenses for the period for each change within a range of reasonably possible changes of the relevant risk variable. Disclosure of the effects of the changes at the limits of the reasonably possible range would be sufficient.

A69 In determining what a reasonably possible change in the relevant risk variable requires that consideration be given to the factors listed below:
(a) A government considers the economic environments in which it operates. A reasonably possible change does not involve remote or "worst case" scenarios or "stress tests". Moreover, if the rate of change in the underlying risk variable is stable, a government need not alter the chosen reasonably possible change in the risk variable. For example, assume that interest rates are five percent and a government determines that a fluctuation in interest rates of ±50 basis points is reasonably possible. It would disclose the effect on surplus or deficit for the period and other if interest rates were to change to 4.5 percent or 5.5 percent. In the next period, interest rates have increased to 5.5 percent. It continues to believe that interest rates may fluctuate by ±50 basis points (i.e., that the rate of change in interest rates

is stable). A government would disclose the effect on surplus or deficit for the period if interest rates were to change to five percent or six percent. A government would not be required to revise its assessment that interest rates might reasonably fluctuate by ±50 basis points, unless there is evidence that interest rates have become significantly more volatile.

(b) The time frame over which it is making the assessment. The sensitivity analysis would show the effects of changes that are considered to be reasonably possible over the period until a government will next present these disclosures, which is usually its next accounting period.

A70 Paragraph .93 allows a government to use a sensitivity analysis that reflects interdependencies between risk variables, such as a value-at-risk methodology, if it uses this analysis to manage its exposure to financial risks. This applies even if such a methodology measures only the potential for loss and does not measure the potential for gain. A government might comply with paragraph .93(a) by disclosing the type of value-at-risk model used (for example, whether the model relies on Monte Carlo simulations), an explanation about how the model works and the main assumptions (for example, the holding period and confidence level). Governments might also disclose the historical observation period and weightings applied to observations within that period, an explanation of how options are dealt with in the calculations, and which volatilities and correlations (or, alternatively, Monte Carlo probability distribution simulations) are used.

A71 A government provides sensitivity analyses for the whole of the reporting entity, but may provide different types of sensitivity analysis for different classes of financial instruments.

Interest rate risk

A72 Interest rate risk arises on interest-bearing financial instruments recognized in the statement of financial position (for example, loans and receivables and debt instruments issued).

Currency risk

A73 Currency risk (or foreign exchange risk) arises on financial instruments that are denominated in a foreign currency, (i.e., in a currency other than a government's reporting currency). For the purpose of this Section, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in a government's reporting currency. It is assumed that a government's summary financial statements are prepared in Canadian dollars.

A74 A sensitivity analysis is disclosed for each currency to which a government has significant exposure.

Other price risk

A75 Other price risk arises on financial instruments because of changes in, for example, commodity prices or equity prices. To comply with paragraph .92(a), a government might disclose the effect of a decrease in a specified stock market index, commodity price, or other risk variable. For example, if a government gives residual value guarantees that are financial instruments, a government

discloses an increase or decrease in the value of the assets to which the guarantee applies.

A76 Two examples of financial instruments that give rise to equity price risk are a holding of equities in another entity, and an investment in an investment pool or sovereign wealth fund, which in turn holds investments in equity instruments. Other examples include forward contracts and options to buy or sell specified quantities of an equity instrument and swaps that are indexed to equity prices. The fair values of such financial instruments are affected by changes in the market price of the underlying equity instruments.

CONSEQUENTIAL AMENDMENTS

The following significant consequential amendment has been identified. Additions are underlined and deletions are struck through.

FINANCIAL STATEMENT PRESENTATION, Section PS 1200

.074 ➤ *The statement of operations should present two components that together explain the change in accumulated surplus/deficit for the period. The statement of operations should:*

(a) report ~~the~~ revenues (other than remeasurement gains) ~~of the accounting period~~ segregated by significant types of revenues from taxes, non-tax sources and transfers from other governments;

(b) report ~~the~~ expenses (other than remeasurement losses) ~~of the period~~ by function or major program;

(c) account for the difference between (a) and (b) ~~the revenues and expenses in the period,~~ as the measure of the surplus ~~or~~/deficit excluding remeasurement gains and losses for the period; ~~and~~

(d) below that component, report remeasurement gains and losses;

(e) report the sum of (c) and (d) as the surplus/deficit for the period; and

~~(d)~~(f) report the accumulated surplus/deficit at the beginning and end of the period;[+] ~~unless these figures are reconciled with the surplus/deficit for the period on a separate statement~~.

.074A ➤ A government may report the accumulated surplus/deficit at the beginning of the period, the change in the accumulated surplus/deficit for the period and the accumulated surplus/deficit at the end of the period in a separate statement. In this case, it should not report the accumulated surplus/deficit at the beginning and end of the period on the statement of operations.

.074B Where a government must report amounts such as other comprehensive income, a separate statement that reports on changes in accumulated surplus/deficit is desirable. A government reports other comprehensive income when it applies the modified equity method in reporting on the results of a government business enterprise or government business partnership that is itself reporting other comprehensive income.

[+] ~~Except for other comprehensive income that may arise in applying the modified equity method when reporting on the results of government business enterprises and government business partnerships (see INCLUDING RESULTS OF ORGANIZATIONS AND PARTNERSHIPS APPLYING FAIR VALUE MEASUREMENT, PSG-6.~~

Details of other significant consequential amendments that would arise from adoption of these proposals will be issued during the comment period. Among matters to be addressed are proposed amendments to FOREIGN CURRENCY TRANSLATION, Section PS 2600.