

Issues Analysis: Financial Instruments

Comments from Staff of the Public Sector Accounting Board

September 2009

- .01 This issues analysis is a supporting document to the Public Sector Accounting Board (PSAB) Exposure Draft “Financial Instruments” (“the ED”). It has been prepared by staff of PSAB to provide further background and to outline some of the alternatives evaluated during due process. The analysis has not been reviewed by the PSAB and, the views expressed are not a position of the Board. Prior to establishing a position, the PSAB will review and deliberate responses submitted to the ED.

Purpose and scope

- .02 The aim is to issue a detailed standard that will improve financial reporting of derivative and non-derivative financial instruments in financial statements prepared in accordance with the PSA Handbook. The proposed standard on Financial Instruments seeks to do this by requiring the recognition of derivatives, consistent reporting of their impact and by improving disclosures associated with financial instruments and financial risks.
- .03 Once issued, the standard will establish the reporting requirements for the assets, liabilities, revenues and expenses that are within the scope of its application. Aspects of these proposals have implications for PSAB’s reporting model, as set out in FINANCIAL STATEMENT PRESENTATION, Section PS 1200. Amending text setting out proposed changes to the statement of operations is included. These proposals are consistent with PSAB’s objectives and concepts to support the objectives of financial reporting by governments.
- .04 A financial instrument is by definition a contractual arrangement between two or more parties. As such, these proposals will not apply to transactions that are not contractual in their nature, such as taxes.
- .05 The rights and obligations inherent in a contract that is a financial instrument give rise to a financial asset for one entity and a financial liability or equity instrument for the other entity to the agreement. PSAB’s reporting model is grounded on distinguishing between assets that are financial resources of a government and those that are non-financial. Financial resources are those items that are expected to contribute to a government’s net cash inflows. These items are described as financial assets in a government’s financial statement and include items such as consumable goods (such as inventories for resale) and when specific criteria are

met¹, an asset held for sale. Although reported among financial assets, these proposals do not apply to inventories or an asset held for sale.

- .06 In the case of certain types of contracts, other detailed standards are in place. Generally, these proposals will not alter the financial reporting of: leases, loan guarantees and, employer obligations associated with employee future benefits.
- .07 The International Public Sector Accounting Board (IPSASB) is currently researching the financial reporting of monetary gold, balances with the International Monetary Fund and liabilities arising from the issuance of currency and coinage. PSAB has not included these items within the scope of these proposals.
- .08 The project did not examine accounting associated with specialized contracts related to insurance, climatic, geological or other physical variables. They are only within the scope when derivatives are embedded in such contracts or the contracts are themselves are exchange traded.

Recognition

- .09 Responses to the Statement of Principles: “Financial Instruments” (“the FI SOP”) supported the principle that recognition should occur when a government becomes a party to the contractual provisions of the financial instrument. The rights and obligations to receive or deliver economic benefits as a party to the contract flow from the point of its inception.
- .10 A government purchasing or selling a financial asset traded on a recognized exchange will recognize an asset and a liability on the date of the trade. This is “trade-date accounting” and is explained further in the Appendix to the ED. The alternative reporting method, “settlement date accounting” is primarily used by organizations measuring income tax obligations. When alternative methods are provided, it adds to the length and complexity of standards and serves to diminish comparability. No specific reasons were given in the response advocating that “settlement date accounting” be continued as a “free choice” alternative. Brokerage statements include information specific to unsettled trades and as such, these amounts can be readily identified and reported.
- .11 When a contract includes provisions that cause certain of its future cash flows to vary as would those of a stand-alone derivative, it is a contract with an embedded derivative. A majority of responses to the FI SOP supported the need to evaluate contracts for the existence of such provisions to maintain the integrity of the standard’s financial reporting requirements for derivatives.
- .12 In support of the need to focus on embedded derivatives with meaningful financial reporting implications, application requirements (paragraphs A18-A26) establish

¹ Paragraph PS 1200.053 sets out criteria that must apply.

principles to determine when an embedded derivative is separately accounted for. In broad terms, the application guidance assists in making this determination.

- (a) It establishes that only embedded derivatives evidencing economic characteristics and risks that are not closely related to the host contract are required to be separately accounted for.
- (b) Illustrative examples are given of situations when an embedded derivative is:
 - (i) not closely related, requiring that it be separately accounted for; and
 - (ii) closely related, requiring that it be recognized and measured along with its host contract.

Measurement

Measurement categories

- .13 All financial instruments within scope will be placed into one of two categories for measurement purposes. The default category is amortized cost and will apply to all financial instruments that are not required to be carried at fair value or designated by a government into the fair value category. PSAB has determined that fair value is needed when items are susceptible to a high degree of variability in their future cash flows, and should be available when governments internally manage and evaluate items on a fair value basis.
- .14 Although some hold the view that historical cost is a feature of the conceptual framework PSAB has adopted, the basis of measurement is a matter settled when individual detailed standards are developed. The conceptual framework recognizes that there are several bases on which an amount can be measured. Assets measured at historical cost are subject to valuation provisions and write-downs. Liabilities such as employee future benefit obligations and contingencies are remeasured applying current information. Discounted future cash flow projections are used in measuring closure and post-closure landfill site liabilities.
- .15 PSAB recognized that determining the basis of measurement would be challenging and controversial. It addressed this issue in a Statement of Principles: “Derivatives” approved in March 2006. The following arguments for recognizing derivatives at fair value were advanced.
 - (a) Amortized historical cost is not a relevant measure of a derivative because the historical cost of a derivative is often zero.
 - (b) Fair values depict the market’s assessment of the present value of the net future cash flows directly or indirectly embodied in all financial instruments, discounted to reflect both current interest rates and the market’s assessment of the risk that the cash flows will not occur.
 - (c) Fair value reflects the current cash equivalent rather than the price of a past transaction.

- .16 Alternatives to existing measures or reasons that cost is a superior measurement approach were not among the arguments advanced in responses. Some assert that any introduction of fair value measurement will affect comparability of results in relation to budget and introduce volatility as changes in fair value caused by “point in time” measurements cannot be reliably anticipated nor provide useful information about the state of a government’s finances.
- .17 PSAB viewed these concerns to be significant. Comparing results reported on with those originally planned provides users with relevant and useful information. PSAB acknowledges the need to ensure that the value of this information is not diminished. In support of this objective, PSAB sought an approach that would maintain the accountability associated with budget comparison, while enhancing key indicators by reporting financial instruments based on principles adopted through due process.

Alternatives evaluated

- .18 Many approaches underwent a preliminary evaluation. Those subjected to a detailed evaluation and abandoned are listed below.
- (a) Reporting derivatives at fair value on the statement of financial position and adjusting accumulated surplus/deficit for remeasurement gains/losses. Recognition through the statement of operations would occur either:
 - (i) through amortization over the instrument’s term, or
 - (ii) when derecognized.
 - (b) Retaining the present accounting treatment for derivatives and disclosing their fair value in the notes to the financial statements.
 - (c) Reporting derivatives at fair value with gains and losses presented as proposed in the FI SOP. Concerns as to the complexity of hedge accounting would be addressed by allowing for the qualitative rather than quantitative evaluation of hedge effectiveness whenever possible. This alternative reflects aspects of an approach advanced by the FASB.²
- .19 This ED adopts an approach judged by PSAB as superior in meeting the financial reporting requirements of the users of government financial statements for several reasons.
- (a) Derivatives are measured at fair value. This is judged as superior to the present treatment as they are consistently measured on a basis that will align public sector standards in Canada with an international consensus. Since PSAB first considered the issue, standards requiring fair value measurement of derivatives have been implemented by all entities that issue GAAP based financial

² In an effort to reduce the complexity of hedge accounting, in June 2008 the Financial Accounting Standards Board (FASB) proposed to amend Statement No. 133, Accounting for Hedging Activities. FASB is considering the input it received as well as feedback received on recent IASB proposals as it develops a new proposal expected to be issued by the end of this year or early 2010.

statements in Canada, other than privately owned entities. GASB has issued³ a final standard that requires derivatives be measured at fair value and IPSASB has issued⁴ a series of exposure drafts that converge with IFRSs.

- (b) Note disclosure is not applied as a substitute in reporting the impact of derivatives on financial position and changes in a government's financial position.
- (c) Gains and losses arising from fair value remeasurement are distinguished from all other revenues and expenses. Two components within the statement of operations will together explain the change in accumulated surplus/deficit. The current accountability comparisons will be maintained by excluding all remeasurement gains and losses required by this ED from the first component.
- (d) The statement of operations will report all changes in assets and liabilities. No gains/losses are posted directly to accumulated surplus or deficit, nor is a concept equivalent to other comprehensive income introduced into public sector reporting. The lower portion of the statement of operations will report all remeasurement gains and losses. By comparison, the other comprehensive income model selectively redirects some gains and losses to the broader measure of comprehensive income. Gains and losses on cash flow hedging instruments⁵ and non-derivative financial instruments designated into the "available-for-sale" category would otherwise be part of net income. While this approach may be useful in measuring profits, it is complex to understand.
- (e) Hedge accounting is not required as realized gains and losses on derivatives as well as hedged items are reported in the first component of the statement of operations. Budget comparisons will apply to the first component but are not anticipated for the second component which reports unrealized gains and losses. The inherent complexity associated with defining hedging relationships and measuring their effectiveness is avoided.
- (f) Alternatives that would amortize gains/losses to future periods were judged to provide less relevant measures. Amortization of a known value, such as the cost of a tangible capital asset, can be useful in allocating costs to future periods. However, amortizing a portion of the change in fair value through does not provide useful information as it is neither representative of the final settlement value (unknown) nor does it reflect current economic events. The pretence of amortization to a future value is a mechanism to smooth results.
- (g) The proposal is superior as it adheres to the conceptual framework, whereas the other alternatives do not. All changes in assets and liabilities arising during the reporting period are reflected in the statement of operations.

³ Accounting and Financial Reporting for Derivative Instruments, Statement No. 53 of the Governmental Accounting Standards Board (GASB), June 2008.

⁴ In April 2009, the International Public Sector Accounting Standards Board (IPSASB) issued three exposure drafts 37, 38 and 39. The exposure drafts are generally equivalent to the International Accounting Standards Board's IFRS standards.

⁵ The portion of the gain or loss on the hedging instrument determined to be an effective hedge.

Equity instruments

- .20 Portfolio investments quoted in an active market are also part of the fair value category, when equity instruments. The SOP proposed all portfolio investments quoted in an active market would be in the fair value category. Now, bonds may be reported at amortized cost. The option to set an accounting policy classifying a group of financial assets, financial liabilities or both for fair value measurement is included. Use of the option is appropriate where a government manages and evaluates an investment fund on a fair value basis. For investments that are managed to maturity, such as a sinking fund, the default category of amortized cost aligns with objectives for holdings of bonds.
- .21 The fair value of equity securities is inherently variable. PSAB believes quoted market values provide reliable and readily obtainable information about this economic resource. When a government holds a security for a long period, cost may provide little relevant information to users. As is the case with derivatives, gains and losses arising from remeasurement at fair value would be reported in the second component on the statement of operations.
- .22 For governments who do not enter into derivatives or invest in equity securities, the proposals will not alter their reported results. Changes arising from implementation of these proposals will be limited to evaluating financial risks and improving disclosures.

Transaction costs

- .23 Accounting for transaction costs depends on the categorization of the associated financial instrument. Transaction costs are not added to financial instruments carried at fair value, as this would be inconsistent with their measurement at fair value. Adding transaction costs would cause the item to be initially recorded at an amount in excess of fair value.

Effective interest method

- .24 Application of the effective interest method was supported in a majority of responses to the FI SOP. Concerns were expressed about the benefit relative to the cost, the ease of application of the straight-line method and a view that the straight-line method better replicates the intended transaction. While all recommendations are subject a materiality evaluation, the straight-line method can significantly overstate yield in the initial reporting period of a multi-period investment.
- .25 The effective interest method exactly discounts estimated future cash payments or receipts throughout the life of the financial instrument. As yield is an important indicator in the evaluation of investment performance, PSAB rejects the view that the straight-line method better replicates the transaction. PSAB asserts that application of the effective yield method improves representational faithfulness. Programs to automate the calculations are readily employed. The transitional timeframe will allow time to update processes. In proposing that the requirements apply prospectively, carrying values and past results would not be restated.

Fair value measurement considerations

- .26 The application of fair value measurement concepts is detailed in the Appendix to the ED. It explains what constitutes a quoted price and how items in the fair value category are measured when a quoted price is not available. When a quoted market value is no longer available for an equity instrument, it is measured at amortized cost (paragraph .38 in the ED). Reclassification to cost will not apply to derivatives. Many derivative contracts are not traded as they are contracts between individual parties. When this is the case, valuation techniques will apply. Only when a derivative is linked to and must be settled by delivery of an unquoted equity investment will it be measured at cost (paragraph .25 in the ED).
- .27 Requirements that govern the application of valuation techniques are based on present international standards. However, PSAB proposes that valuation techniques will play a limited role in financial reporting by governments as they will be employed only to measure derivatives and certain non-derivative items designated into the fair value category by a government, for which a quoted price is not available. As explained in paragraph .25 in the ED, equity instruments are only measured at fair value when a quoted price in an active market is available.

Impairment

- .28 Responses broadly supported maintaining present standards to assess impairment. In this regard, the ED will establish no new requirements. Governments will evaluate financial assets for impairment. Increases in valuation provisions and write-downs will be reported as expenses that are not remeasurement losses. This presentation reflects an assessment that there has been a change in the economic resources available to the government during the period.

Reclassifications

- .29 Reclassification of an equity instrument occurs when it no longer qualifies to be included in the fair value category. For equity instruments that are portfolio investments, this occurs when a quoted price is no longer available. Fair value measurement resumes when a quoted price becomes available. This is not expected to occur frequently, but the standard provides for this eventuality.
- .30 Reclassifications arising from other circumstances are not permitted. As outlined earlier, hedge accounting is not provided for as remeasurement gains and losses are reported separately in the statement of operations. Thus, the need for an accounting construct to support the “matching” of unrealized gains and losses to realized revenues and expenses is redundant.
- .31 The fair value option may be used when non-derivative financial assets and non-derivative financial liabilities are managed and evaluated on a fair value basis. The government would adopt an accounting policy to report specific classes at fair value. Any change would be an accounting policy change and not a reclassification. The requirements in ACCOUNTING CHANGES, Section PS 2120 would apply.

Derecognition of financial liabilities

- .32 Principles and interpretative text support the consistent reporting of liabilities. Liabilities are derecognized (removed) when contractually extinguished. The adoption of these principles was supported in a significant majority of responses.
- .33 Concerns were expressed in several responses that application of these principles would influence investment and debt management by governments. The issue arises when a government (or a governmental unit being an organization controlled by the government, that is not a government business enterprise), purchases a debt instrument issued by that government. This purchase may be to acquire a portfolio investment or in support of market operations. Since a government cannot owe money to itself, when it or a governmental unit reacquires that obligation, the obligation is effectively repaid. When presented otherwise, arguably both the government's portfolio investments and its debt obligations are overstated.
- .34 PSAB evaluated this issue and determined that the principles and interpretative text proposed are consistent with present requirements. Specifically, BASIC PRINCIPLES OF CONSOLIDATION, paragraph PS 2500.06 states:
- “Government financial statements should consolidate governmental units on a uniform line-by-line basis on a uniform basis of accounting after eliminating inter-governmental unit transactions and balances.”
- .35 The requirement to consolidate balances of a controlled entity on a line-by-line basis does not extend to government business enterprises. The modified equity method applies as required by INVESTMENTS IN GOVERNMENT BUSINESS ENTERPRISES, Section PS 3070. Specifically, paragraph PS 3070.29-.30 states:
- “Inter-organizational transactions and balances are not eliminated under the modified equity method.”
- “Inter-organizational gains and losses are, however, eliminated on the assets remaining within the government reporting entity at the financial statement reporting date...”
- .36 A special case⁶ is the reporting of inter-organizational bond holdings. Consistent with principles cited above and notwithstanding requirements to report government business enterprises on a modified equity basis, when a government organization purchases a bond of a government business enterprise, or visa versa, paragraph PS 3070.35 requires:
- “...a constructive gain or loss, equal to the difference between the carrying value of the debt in the accounts of the issuer and the cost to the acquirer, is recognized in the government consolidated financial statements at the date of acquisition.”

⁶ Paragraph PS 3070.39 states “the application of paragraphs PS 3070.35-.38 to acquisitions of the debt of government organizations by government sinking funds is not addressed in this Section.”

- .37 As such, this derecognition principle does not establish new requirements as present standards achieve substantially the same result, both in terms of the reporting of financial position and in reporting on operations.
- .38 Two responses cited situations where governments reacquire outstanding debt obligations as part of a program aimed at reducing ongoing interest expense and/or foreign currency risk exposure. A new debt issue may replace obligations that were retired when the government does not have the fiscal capacity to reduce its overall debt. The response suggested that any unamortized debt issuance costs and gains/losses associated with legacy bonds purchased under these programs be added to the issuance costs of the replacement debt issue.
- .39 In establishing a principle that would distinguish exchanges of debt obligations that involve substantially different terms from those that do not, PSAB seeks to ensure that consistent treatment is given to the recognition of debt issuance costs. While the objectives of debt substitution programs are laudable, any difference between the market price of the bond and its issue price reflects market activity. It is not clear why such gains and losses should not be realized when the decision is made. Governments continually face decisions that involve committing current resources to realize a future saving; in many cases such spending is not deferred.

Presentation of remeasurement gains and losses

- .40 Distinguishing remeasurement gains and losses from other revenues and expenses reflects a view that when items continue to be held, the gains and losses arising from their remeasurement are not absolute.
- .41 Users will continue to seek a summary measure of results that supports budget-to-actual comparisons. The approach proposed strikes a balance between the need to improve the reporting of financial instruments and maintaining measures relevant to budget-to-actual comparisons.
- .42 The first component reports revenues (other than remeasurement gains) and expenses (other than remeasurement losses). As such, remeasurement gains and losses will not be reported on those lines against which budget comparisons will be expected and users will be provided with a net measure for accountability purposes.
- .43 When reporting on remeasurement gains and losses in the second component, a government may aggregate all items on a single line or provide more detail. Disclosure requirements ensure that supporting information is available where a government chooses to report all remeasurement gains and losses on a single line.
- .44 When a financial instrument carried at fair value is derecognized, the gain or loss is reported in the first component of the statement of operations. Any remeasurement gains and losses previously reported are reversed within the second component. An illustration is provided, see paragraph A47 in the ED.

Presentation

Offsetting of a financial asset and a financial liability

- .45 The FI SOP limited offsetting of a financial asset and a financial liability to situations where a legal right of offset was in place and would be exercised. Responses were mixed on this position. Those who disagreed asserted that synthetic instrument accounting reflects the economic substance of the transactions (structured on the expectation the derivative will be held to maturity) thereby providing direct, useful and simple information to the users of financial statements. The view was that the substance of the transaction outweighs its legal form.
- .46 Another response expressed the view that the risk associated with credit events is nonexistent when a government deals with reputable institutions whose credit rating is higher than its own. Recent economic events demonstrate that the credit ratings of banks and other derivative issuers may on occasion be subject to rapid and dramatic changes. The international consensus is that users deserve the transparency provided when contracts without a legally enforceable right of set off are reported separately. The ED adopts this position based on the view that limiting “offsetting” enhances representational faithfulness.

Financial statement disclosures

- .47 The financial statement disclosure requirements support the needs of users who wish to evaluate the significance of financial instruments to the financial position and changes in financial position for the reporting period.
- .48 PSAB proposes only two measurement categories and generally establishes the financial instruments that will populate each category. This diminishes disclosure requirements, as otherwise users seek information about the implications of these decisions. The ED focuses on providing users with further details when individual financial statement lines include various types of items and varying bases of measurement.
- .49 More detailed requirements apply to items designated into the fair value category. These requirements appear in the Appendix and are cross referenced to the body of the ED.
- .50 Other key aspects of the ED note disclosure requirements are set out below.
- (a) Details of remeasurement gains and losses are to be presented.
 - (b) Governments holding derivatives explain their purpose and their use in managing risk. These disclosures are to be presented in a manner that compliments the risk disclosures.
 - (c) Where a government uses valuation techniques it discloses its methods and key assumptions applied.

- (d) When financial instruments are carried at fair value, summary disclosure of measurement techniques employed is disclosed, based on a hierarchy. This three level hierarchy is in common use and knowledgeable users will be familiar with it. It assists users in understanding the nature of the underlying data used in establishing fair value.
- (e) Disclosures of fair value will not be required for financial assets and financial liabilities reported at amortized cost other than portfolio investments.

Risk disclosures

- .51 These requirements are included to serve the needs of users who wish to understand the nature and extent of risks arising from financial instruments held by a government at the reporting date.
- .52 Risk disclosures may be provided in the notes or in a financial statement discussion and analysis (when it is an integral part of and is cross referenced to the financial statements). A government will have the flexibility to integrate a discussion of financial risk into broader discussions of the risks it faces.
- .53 Both qualitative and quantitative analyses are to be provided. The discussion portion is to focus on financial risks arising from holdings of financial instruments. A government sets out its objectives, policies and processes to manage these risks and any changes since the last reporting period.
- .54 The quantitative analyses are organized according to the nature of the risk exposure. This would include: credit risk, liquidity risk and the three forms of market risk (i.e., currency risk, interest rate risk and other price risk). Where a government employs techniques that reflect interdependencies between risk variables, it is provided with the option of providing its market risk analysis in this manner.