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ASSURANCE AND ACCOUNTING

# A GUIDE TO ACCOUNTING FOR FINANCIAL INSTRUMENTS IN THE PUBLIC SECTOR

In June 2011, the Public Sector Accounting Standards Board released Section PS3450, Financial Instruments. This standard establishes how to account for and report all types of financial instruments, including derivatives. As all public sector entities have financial instruments, this standard is important and all entities should have an understanding of its impact. In addition to PS3450, the Board also introduced Sections PS2601, Foreign Currency Translation, and PS1201, Financial Statement Presentation, to replace PS2600 and PS1200 respectively. PS1000, Financial Statement Concepts, and PS1100, Financial Statement Objectives, were also amended.

These new and amended standards are effective for government organizations (i.e. Government Not-for-Profit Organizations (GNPOs) and Other Government Organizations (OGOs)) for fiscal years beginning on or after April 2012. Governments will not be required to adopt these standards until fiscal years beginning on or after April 1, 2015. Early adoption is permitted; however, an entity must adopt PS3450 and PS2601 at the same time.

Government organizations have an earlier adoption date due to the fact many will be moving to Public Sector Accounting Standards for the first time in 2011 or 2012 and many have already been applying somewhat similar financial instrument standards under their current accounting frameworks. In fact, it may be beneficial for many government organizations to early adopt these standards on their transition to Public Sector Accounting Standards.

The delay in adoption for governments will allow the Board to review the application of these standards to governments. The Board has committed to complete this review by December 31, 2013. We do not anticipate these standards being eliminated for governments; however, it is possible that the standards will be amended prior to governments being required to apply the standards.

## Scope

Financial instruments are contracts that give rise to a financial asset of one entity and a financial liability or equity instrument of another entity. To understand this definition we must also define a financial asset, financial liability and equity instrument:

- **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 liabilities** are any liabilities that are contractual obligations to deliver cash or another financial asset to another entity; or to exchange financial instruments with another entity under conditions that are potentially unfavourable to a government; and
- **Equity instruments** are any contracts that evidence a residual interest in the assets of an entity after deducting all of its liabilities.

In general, a financial instrument is a contractual right or obligation to receive or deliver cash or another financial instrument or exchange financial instruments. In fact, a chain of contractual rights or 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.

It is important to note that the definition of a financial asset is not consistent with the definition of a financial asset as defined in PS1201. PS1201 includes inventories of supplies, although the control of such assets provides an opportunity to produce or supply goods and services, they do not give rise to a present obligation to receive cash or another financial asset.

Financial instruments include primary instruments, such as cash, bank deposits, receivables, payables and equity instruments, and derivative financial instruments. Derivatives are financial instruments or other contracts with all three of the following characteristics:

- 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");
- 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
- They are settled at a future date.

Common examples of derivatives include options, warrants, futures contracts, forward contracts, and interest rate and currency swaps.

In general, PS3450 applies to all financial instruments; however, there are some financial instruments which are excluded from the scope of the standard. Most of these exclusions relate to instruments which meet the definition of a financial instrument; however, the accounting for these items is determined by another standard (for example, lease accounting)[1].

Contracts to buy or sell non-financial items generally do not meet the definition of financial instruments 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 to receive, deliver or exchange a financial asset. However, contracts to buy and sell non-financial items in quantities in excess of the entities expected purchase, sale or usage requirements where the contract can be settled net or by exchanging financial instruments are within the scope of these standards.

## Recognition and Measurement

### Initial Recognition

Financial instruments should be recognized on the statement of financial position when the entity becomes party to the contractual provisions of the instrument. In the case of the purchase or sale of financial assets traded on a recognized exchange, these must be recognized on a trade-date basis.

On initial recognition, transaction costs are added to the carrying value of items measured at cost or amortized cost. For items measured at fair value, transaction costs are expensed as incurred. See the guidance on Subsequent Measurement below for which instruments are measured at amortized cost and which instruments are measured at fair value.

### Embedded Derivatives

A contract 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 separate from its host contract. An embedded derivative is recognized separately from its host contract if all of the following conditions are met:

- The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract[2];
- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- The combined instrument is not measured at fair value (i.e., derivatives embedded in financial instruments in the fair value category are not separated).

[1] See PS3450.003 for a complete list of the items excluded from the scope of Section PS3450.

[2] See PS3450.A25 and A26 for examples of economic characteristics and risks that would and wouldn't be considered closely related to the host contract.

If an embedded derivative is separated, the host contract would be accounted for by applying the provisions in PS3450 if it is a financial instrument, and in accordance with other appropriate standards if it is not a financial instrument. Common examples of contracts that contain embedded derivatives that would require separation include:

- An option to extend the remaining term to maturity of a debt unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension;
- Commodity-indexed interest or principal payments in a host debt instrument — by which the amount of interest or principal is indexed to the price of a commodity (such as oil); and
- A prepayment option on a debt contract unless the option's exercise price is approximately equal on each exercise date to the amortized cost of the host debt instrument.

Embedded derivatives can also be in contracts that are not financial instruments, such as leases and purchase orders. As a result, any time an entity enters into a contract; it will have to be assessed for embedded derivatives.

The assessment of whether an embedded derivative is required to be separated is completed at the time of initial recognition. 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.

For government organizations that are transitioning from Part IV of the Canadian Institute of Chartered Accountants (CICA) Accounting Handbook to Public Sector Accounting Standards, these requirements will look very similar to the embedded derivative requirements of Section 3855, Financial Instruments: Recognition and Measurement.

## Subsequent Measurement

The measurement of financial instruments subsequent to initial recognition will depend on the type of instrument as well as the accounting policy choices made by the entity. The following instruments are required to be measured at fair value with changes in fair value[3] recognized in surplus (deficit):

- Investments in equity instruments that are quoted in an active market[4]; and
- Derivative contracts other than those that are linked to and must be settled by delivery of unquoted equity instruments (e.g. an option of shares of a private company).

All other financial assets and financial liabilities are measured at cost or amortized cost using the effective interest rate method[5].

An entity that manages and reports performance for groups of financial assets, financial liabilities or both on a fair value basis may elect to measure these instruments at fair value by designating that specific financial instrument when it is initially recognized or when an equity instrument ceases to be quoted in an active market. An entity that has an investment portfolio made up of stocks and bonds, both which are quoted in active market, is an example of where this election may be used for the bonds to ensure that both types of financial instruments are measured on the same basis. An entity may also make such a designation for contracts that contain embedded derivatives that would require separation, as it may be more practical to designate the entire instrument for fair value measurement rather than separately account for its derivative features.

The classification of an instrument into the fair value or cost or amortized cost categories is not revisited unless a quoted price in an active market ceases to be available or becomes available for an equity instrument. When a quoted price in an active market is no longer available, the equity instrument should be measured at cost, with the most recent quoted price becoming its new cost. When a quoted price in an active market becomes available for an equity instrument that was previously recorded at cost, the equity instrument should be remeasured at fair value and the difference between its carrying value and fair value reported as a remeasurement gain or loss in the statement of remeasurement gains and losses.

## Impairment

All non-derivative financial assets, regardless of whether they are measured at fair value or cost or amortized cost must be assessed at each financial reporting date to determine if there is any objective evidence of impairment. If such evidence exists, the entity will apply the guidance related to impairment in PS3040, Portfolio Investments, or PS3050, Loans Receivable[6]. The requirements in PS3040 and PS3050 are unchanged on the issuance of these new standards.

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. Impairment losses are reported in the statement of operations.

[3] The best evidence of fair value is quoted prices in an active market. 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. If the market for a financial instrument is not active, fair value is established 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.

[4] 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.

[5] The effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability) 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.

[6] An exposure draft is currently outstanding which proposes to eliminate PS3040 and PS3050 and incorporate these requirements into PS3450.

## Derecognition of Financial Liabilities

A financial liability should only be removed from the statement of financial position when it is extinguished. An obligation is extinguished when the obligation is discharged, cancelled or expired. Legal release from the creditor is essential. For example in-substance defeasance or a payment to a third party to assume a debt obligation will not result in the financial liability being derecognized without legal release from the creditor.

In addition, exchanges of debt instruments or modifications of debt instruments must be considered to determine if an extinguishment has occurred. If the terms are substantially different[7] the exchange or modification should be accounted for as an extinguishment of the original instrument and the recognition of a new financial liability. The difference between the fair value of the new financial instrument and the carrying amount of the original instrument would be recognized as a gain or loss in the statement of operations.

## Presentation

### Remeasurement Gains and Losses

The introduction of these new and amended standards also results in a new primary financial statement being introduced, the statement of remeasurement gains and losses. This statement will be used to distinguish remeasurement gains and losses from the operating revenues and expenses. Remeasurement gains and losses include unrealized changes in fair value of instruments measured at fair value and unrealized foreign exchange gains and losses. Note that impairment losses discussed above are not considered remeasurement gains or losses and are recorded in the statement of operations.

Remeasurement gains and losses will be accumulated in the statement of remeasurement gains and losses until the financial instrument they are associated with is derecognized. Upon derecognition of the instrument, the remeasurement gains and losses are reclassified to the statement of operations.

The following is an example of statement of remeasurement gains and losses:

**Local Government Sample**

**Statement of Remeasurement Gains and Losses**

| For the year ended December 31 | 20X9 | 20X8 |
|---|---|---|
| | **('000s)** | ('000s) |
| **Accumulated remeasurement gains (losses)**, beginning of year | $ (47) | $ - |
| Unrealized gains (losses) attributable to: | | |
| Foreign exchange | (35) | - |
| Derivatives | 130 | (105) |
| Portfolio Investments | 54 | 108 |
| | 149 | 3 |
| Amounts reclassified to the statement of operations: | | |
| Portfolio investments | 20 | (50) |
| **Accumulated remeasurements gains (losses),** end of year | 122 | (47) |

[7] 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% different from the discounted present value of the remaining cash flows of the original financial liability.

It is also important to note that the introduction of these new amended standards eliminates hedge accounting. Hedge accounting is eliminated due to the fact that all remeasurement gains and losses, including those related to derivatives are now recognized in the statement of remeasurement gains and losses.

In addition to introducing this new statement, changes are also required to the statement of financial position and statement of changes in net debt to reflect the fact that these amounts are measured at fair value in the statement of financial position, but the change in fair value is not reflected in the annual surplus or deficit.

On the statement of financial position the accumulated surplus will now have to be reconciled to the accumulated operating surplus and the accumulated remeasurement gains and losses:

## Local Government Sample

### Consolidated Statement of Financial Position

| **For the year ended December 31** | **20X9 ('000s)** | 20X8 ('000s) |
|---|---|---|
| **Financial Assets** | | |
| Cash and cash equivalents | $ 1,577 | $ 1,366 |
| Accounts receivable | 1,864 | 1,708 |
| Portfolio investments (Note 1) | 7,031 | 6,932 |
| Business enterprise equity (Note 2) | 331 | 207 |
| Inventories for resale | 109 | 135 |
| | 10,912 | 10,348 |
| **Liabilities** | | |
| Accounts payable and accrued liabilities | 2,383 | 2,644 |
| Debt (Note 3) | 9,363 | 9,796 |
| Pensions and other employee benefits (Note 4) | 4,813 | 4,890 |
| Other accrued liabilities | 1,703 | 1,841 |
| | 18,262 | 19,171 |
| Net financial assets (debt) | (7,350) | (8,823) |
| Non financial assets (Note 5) | | |
| Tangible capital assets (Note 6) | 87,218 | 97,215 |
| Inventories of supplies | 112 | 222 |
| Prepaid expenses | 30 | 20 |
| | 87,360 | 97,457 |
| Accumulated surplus (Note 7) | **$ 80,010** | **$ 88,634** |
| Accumulated surplus (deficit) is comprised of: | | |
| Accumulated operating surplus (deficit) | $ 79,888 | $ 88,681 |
| Accumulated remeasurement gains (losses) | 122 | (47) |
| | $ 80,010 | $ 88,634 |

The statement of changes in net debt will now have to include an additional line item to account for the remeasurement gains and losses.

## Local Government Sample

### Consolidated Statement of change in net debt

| For the year ended December 31 | 20X9 Budget ('000s) | 20X9 Actual ('000s) | 20X8 ('000s) |
|---|---|---|---|
| **Revenues** | | | |
| Annual deficit | $ (9,972) | $ (8,624) | $ (7,449) |
| Acquisition of tangible capital assets | (294) | (294) | (250) |
| Amortization of tangible capital assets | 10,000 | 10,226 | 10,230 |
| (Gain) / loss on sale of tangible capital assets | - | (5) | (19) |
| Proceeds on sale of tangible capital assets | - | 46 | 72 |
| Write-downs of tangible capital assets | - | 24 | 44 |
| | (266) | 1,373 | 2,628 |
| Acquisition of supplies inventories | - | - | (324) |
| Acquisition of prepaid expense | - | (30) | (20) |
| Consumption of supplies inventories | - | 110 | 102 |
| Use of prepaid expense | - | 20 | - |
| | - | 100 | (242) |
| | (266) | 1,473 | 2,386 |
| Net remeasurement gains (losses) | - | 122 | (47) |
| **Change in net financial assets / net debt** | (266) | 1,595 | 2,339 |
| **Net financial assets (net debt)**, beginning of year | (8,870) | (8,870) | (11,209) |
| **Net financial assets (net debt)**, end of year | $ (9,136) | $ (7,275) | $ (8,870) |

### Offsetting

Section PS3450 introduces guidance related to the offsetting of financial assets and liabilities. 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, an entity:

- Currently has a legally enforceable right to set off the recognized amounts; and
- Intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

Existence of the right to offset alone does not provide sufficient basis for offsetting, as the absence of an intention to settle the instruments simultaneously does not affect future cash flows. For example, master netting agreements, which are often entered into to provide the right to offset only in the event of default, will not meet the offsetting requirements.

### Disclosure

The extent of disclosure required by Section PS3450 is very significant. For government organizations that are transitioning to Public Sector Accounting Standards, these requirements will look very similar to Section 3862, Financial Instruments: Disclosures. The underlying principle of these disclosure requirements is that information should be disclosed that enables users of the financial statements to evaluate the significance of financial instruments on the organizations financial position and changes in its financial position.

These disclosures include information related to[8]:

- The carrying amount of the instruments by category of subsequent measurement;
- Financial assets pledged as collateral;
- Defaults and breaches of the terms of any loans payable;
- The purpose of its use of derivatives; and
- Fair value measurements using a fair value hierarchy.

There are also significant disclosure requirements related to the nature and extent of risks arising from financial instruments. These risks include credit, liquidity and market risk. Market risk includes interest rate, currency and other price risk. For each type of risk both qualitative and quantitative disclosures are required. These disclosures include[9]:

- Concentrations of credit risk and the maximum exposure to credit risk;
- The credit quality of financial assets, including an analysis of the age of financial assets that are past due but not impaired;
- A maturity analysis of financial liabilities that shows the remaining contractual maturities; and
- A sensitivity analysis for each type of market risk.

For organizations that have large investment portfolios, enter into complex financing transactions or utilize derivative instruments, the additional disclosures required by Section PS3450 will be significant.

## Transitional Provisions

As mentioned above the new and amended standards have a dual mandatory effective date – fiscal years beginning on or after April 1, 2012 and 2015 for government organizations and governments respectively.

When transitioning, comparative periods are not to be restated. At the beginning of the fiscal year in which these standards are applied, an entity[10]:

- Recognizes all financial assets and financial liabilities on its statement of financial position and classifies items in accordance with the Standard;
- Applies the criteria in to identify those financial assets and financial liabilities to be measured at fair value; and
- Remeasures assets and liabilities as appropriate. Any adjustment of the previous carrying amount is recognized as an adjustment to the accumulated remeasurement gains and losses at the beginning of the fiscal year in which this Section is initially applied.

With regards to embedded derivatives an accounting policy choice exists. An entity may choose to apply the requirements related to embedded derivatives on a prospective or retrospective basis.

The transitional provisions also provide guidance for organizations that adopt these standards in the same period they adopt Public Sector Accounting Standards for the first time. First time adopters cannot adopt these standards retrospectively, therefore comparative amounts are presented in accordance with the accounting policies applied immediately preceding its adoption of Public Sector Accounting Standards.

## Conclusion

The adoption of Section PS3450 and the related standards and amendments will be a significant change for most public sector organizations. Talk to your BDO advisor to understand the impact it will have on your organization.

[8] The details of these disclosures are included in paragraphs PS3450.068-.084 and A48-A54.

[9] The details of these disclosures are included in paragraphs PS3450.085-.096 and A55-A76.

[10] There are additional transitional provisions related to foreign exchange translations and for entities who previously applied hedge accounting. These are located in paragraph 25 of PS 2601.