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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.

Ten years after the adoption by certain government organizations[1], these standards and amendments will be adopted by Governments for fiscal years beginning on or after April 1, 2022.

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 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.

[1] Government Organizations that applied the CPA Canada Handbook – Accounting prior to their adoption of the CPA Canada Public Sector Accounting Handbook, adopted these standards in fiscal years beginning on or after April 1, 2012.

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, some financial instruments are excluded from the scope of the Standard. Most of these exclusions relate to instruments that meet the definition of a financial instrument; however, the accounting for these items is determined by another standard (for example, lease accounting)[2].

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 entity's 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.

This Section also applies to the following scenarios:

- Reinsurance contracts that involve the transfer of financial risks and apply to derivatives that are embedded in insurance contracts held by the government; and
- Financial guarantee contracts that provide for payments 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.

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

- 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; and
- Loan commitments that can be settled net in cash or by delivering or issuing another financial instrument – these loan commitments are derivatives.

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[3];
- 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).

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 or automatic provision to extend the remaining term to maturity of debt unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension;

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

[3] 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.

- Equity-indexed interest or principal payments in a host debt instrument – by which the amount of interest or principal is indexed to the value of equity instruments;
- 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);
- 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; and
- Credit derivatives that are embedded in a host debt contract and allow the beneficiary to transfer the credit risk of a reference asset to the guarantor.

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 contract that significantly modifies the cash flows that otherwise would be required under the contract.

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[4] recognized in surplus (deficit):

- Investments in equity instruments that are quoted in an active market[5]; 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[6].

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. For example, an entity that has an investment portfolio made up of stocks and bonds, both of which are quoted in an active market, may use this election 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 should be 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 PS3041, *Portfolio Investments*, or PS3050, *Loans Receivable*.

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.

[4] 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.

[5] 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.

[6] AThe 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.

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. A financial liability may only be extinguished by paying the creditor or by being legally released from the primary responsibility of the liability by the creditor or the by legal process.

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.

When an entity repurchases its own debt instrument, the repurchased instrument and the original financial liability should be offset in the Statement of Financial Position and the interest revenue and interest expense associated with this repurchased debt instrument should be offset in the Statement of Operations. Bond repurchase transactions are only treated as extinguishments if they meet the above criteria for derecognition.

Presentation

Remeasurement Gains and Losses

The adoption 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 the fair value of instruments measured at fair value. They will also include unrealized foreign exchange gains and losses unless the entity makes an irrevocable election to recognize exchange gains and losses directly in the statement of operations on initial recognition of the financial instrument. There is also an exception for changes in fair value for externally restricted financial assets.

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 or impaired. Upon derecognition of the instrument, the remeasurement gains and losses are reclassified to the statement of operations. If the asset is impaired, the impairment loss is reclassified into the statement of operations.

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

Local Government Sample
Statement of Remeasurement Gains and Losses

For the year ended December 31	**20X3 ('000s)**	20X2 ('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)

It is also important to note that the adoption of the standard 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. There has also been an amendment to the statement of changes in net debt to show the change in net debt excluding net remeasurement gains and losses.

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:

[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.

[8] Externally restricted financial assets should be accounted for in accordance with Section PS 3100.11, *Restricted assets and revenues* which state that "Externally restricted inflow should be recognized as revenue in a government's financial statements in the period in which the resources are used for the purposes specified. An externally restricted inflow received before this criterion has been met should be reported as a liability until the resources are used for the purpose of purposes specified."

Local Government Sample
Consolidated Statement of Financial Position

For the year ended December 31	**20X3 ('000s)**	20X2 ('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 sale	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 (defecit) is comprised of:	$ 79,888	$ 88,681
Accumulated operating surplus (deficit)	$ 122	- $ 47
Accumulated remeasurement gains (losses)	$ 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	**20X3 Budget ('000s)**	**20X3 Actual ('000s)**	20X2 ('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)
Decrease in net debt excluding net remeasurement gains and (losses)	(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
- It intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

When these conditions are met, the entity has, in effect, a single cash flow and a single financial asset or liability.

The existence of the right to offset alone does not provide a sufficient basis for offsetting, as the absence of an intention to settle the instruments simultaneously does not affect future cash flows. The expectation is that these conditions are generally not satisfied, and offsetting is usually inappropriate in the following scenarios:

- Master netting agreements, which provide the right to offset only in the event of default;
- Several different financial instruments are used to emulate the features of a single financial instrument (a "synthetic instrument");
- Financial instruments have the same primary risk exposure but involve different counterparties (e.g. assets and liabilities within a portfolio of derivative instruments).
- Financial or other assets are pledged as collateral for non-recourse financial liabilities;
- Financial assets are set aside in trust by a debtor to discharge an obligation without those assets having been accepted by the creditor in settlement of the obligation (e.g. a sinking fund arrangement); or
- Financial obligations that are expected to be recovered through an insurance claim.

Disclosure

The extent of disclosure required by Section PS3450 is very significant. 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 organization's financial position and changes in its financial position.

These disclosures include information related to[9]:

- 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[10]:

- 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 standards and amendments have a mandatory effective date – fiscal years beginning on or after April 1, 2022 (with the exception of the government organizations that adopted on April 1, 2012).

When transitioning, comparative periods are not to be restated. At the beginning of the fiscal year in which these standards are applied, an entity[11]:

- 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, for instruments measured at fair value, 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.
- For financial assets or liabilities measured at amortized cost with associated unamortized discount, premium or transaction costs, these costs should be included in the instrument's opening carrying value.

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.

Controlling governments should use carrying values of the financial assets and liabilities in the records of its government organizations on consolidation.

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.

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

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

[11] 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.

The information in this publication is current as of April, 2022.

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