Financial Instruments: Foreign Exchange Narrow-scope Amendments, Sections PS 1201, PS 2601 and PS 3450 — Basis for Conclusions

FOREWORD

The primary objective of a Basis for Conclusions document is to set out how the Public Sector Accounting Board (PSAB) reached its conclusions. As well, it sets out significant matters arising from comments received in response to the proposals exposed and indicates how the Board has dealt with the issues raised.

These documents are intended to assist financial statement users, preparers, auditors and other parties interested in public sector financial reporting in understanding the rationale PSAB follows when developing or amending standards.

This document has been prepared by staff of PSAB. It does not form part of the CPA Canada Public Sector Accounting (PSA) Handbook nor is it part of public sector generally accepted accounting principles. Basis for Conclusions documents also do not include any guidance on the application of the relevant Section or Guideline.

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BACKGROUND

.1 In January 2020, PSAB issued the Exposure Draft, "*Financial Instruments: Federal Government Narrow-scope Amendments."* The Exposure Draft reaffirmed that the federal government was subject to scope exemptions from FOREIGN CURRENCY TRANSLATION, Section PS 2601, and could continue to present the exchange gains and losses relating to its foreign reserves directly in the statement of operations. The Exposure Draft also proposed new scope exemptions to allow the federal government to present exchange gains and losses on associated derivatives directly in the statement of operations. The proposals in this Exposure Draft were approved by the Board in July 2020.

RATIONALE FOR AMENDMENTS

.2 In reviewing feedback received on the above Exposure Draft, the Board noted that many respondents had encouraged PSAB to expand the presentation being provided to the federal government to other public sector entities. Respondents highlighted that other entities could benefit from this presentation as this would allow for better matching of their exchange gains and losses with derivatives intended to mitigate foreign currency risk. Consultation with certain stakeholders also indicated that this presentation would minimize volatility and allow for more flexibility in engaging in foreign currency risk management transactions, such as back-to-back hedges.

.3 Some respondents also raised concern over the application of scope exemptions provided to only one public sector entity. They highlighted that this could undermine a general-purpose accounting framework and reduce comparability. Further, some respondents did not feel that sufficient rationale was provided by PSAB to justify why the federal government should be subject to a distinctive accounting treatment.

.4 PSAB agreed with the feedback above and has expanded the accounting treatment provided to the federal government through a general accounting policy election available to all public sector entities. This election broadens the accounting treatment to any financial asset or financial liability arising from a foreign currency transaction. The Board believes this results in a presentation that provides transparent information to users.

.5 In January 2021, PSAB also issued two new Exposure Drafts for public comment, "*The Conceptual Framework for Financial Reporting in the Public Sector"* and *"Financial Statement Presentation, Proposed Section PS 1202."* If the proposals in these Exposure Drafts are approved as drafted, the references to "financial asset" and "financial liability" throughout these amendments will be replaced with "financial instrument asset" and "financial instrument liability". These changes will also apply to terminology used throughout this Basis for Conclusions.

INTRODUCTION OF ACCOUNTING POLICY ELECTION

Main features of accounting policy election

.6 As described above, PSAB has amended Section PS 2601 to include an accounting policy election. This election allows all public sector entities to recognize exchange gains and losses on a financial asset or financial liability arising from a foreign currency transaction directly in the statement of operations. For a financial asset or financial liability in the fair value category, such as a derivative, the exchange gain or loss component of the change in fair value is separated and recognized directly in the statement of operations. Amounts subject to this election would not be recognized in the statement of remeasurement gains and losses.

.7 The fair value of a derivative includes several components, including exchange gains and losses, interest rate gains and losses, and credit risk. The exchange gain or loss component of the fair value change of a derivative represents the change in value driven by movements in foreign exchange rates. This component can be segregated and presented separately. Accordingly, this election allows the exchange gain or loss component of a derivative to be recognized in the statement of operations within the same period as underlying risk-managed exchange gains and losses.

.8 This is an irrevocable election available only upon initial recognition of a financial asset or financial liability. PSAB believes that this election should be structured in this manner so that entities are unable to alter their accounting presentation based on the performance of their foreign currency transactions. For example, this would prohibit entities from presenting exchange gains through the statement of operations but subsequently deferring exchange losses through the statement of remeasurement gains and losses.

Feedback from respondents on main features

.9 One respondent to the Exposure Draft raised uncertainty over what initial recognition would mean for a derivative. Based on the existing guidance outlined in paragraphs PS 3450.009–.011, the Board believes it is clear that the initial recognition of a derivative would be when an entity becomes party to the contractual provisions of the instrument. This would be irrespective of whether there was a value associated with the contract. Further clarification on this point has not been included within the amendments.

.10 One respondent also encouraged PSAB to provide further guidance on the type of audit evidence required to make this election. Standard setters do not typically prescribe this type of guidance. However, the Board recognizes that documentation would be important to demonstrate that this election was made on initial recognition of a financial asset or financial liability.

.11 PSAB received some mixed feedback from Exposure Draft respondents on the irrevocable nature of the election. While one respondent indicated that this could be difficult for preparers as government direction can change over time, another noted that this would be appropriate to prevent the manipulation of results. Overall, the Board felt that irrevocability was an important principle to maintain for the reasons cited in paragraph 8 above. It also recognized that, while irrevocable, some degree of flexibility was provided as the election could be made separately for individual financial assets and financial liabilities.

.12 A few respondents to the Exposure Draft encouraged PSAB to provide additional clarification on how this election could be made. As a result, wording has been included within PS 2601 to indicate that this election is made on an instrument-by-instrument basis. While this was the Board's intent upon development of these amendments, some respondents felt that the nature of application was not clear or should be stated more explicitly within the standard. The Board believes that this approach is appropriate as it provides public sector entities with the discretion to make this election based on how their foreign currency risk is managed. This approach does not restrict entities by forcing them to make an irrevocable election for all or significant groups of financial assets and financial liabilities.

Comparison to federal government scope exemptions

.13 Unlike the scope exemptions provided to the federal government described above, this accounting policy election does not specify the foreign currency balances or associated derivatives subject to this accounting treatment. PSAB believes that this is a better approach for general application as the types of foreign currency balances held, including derivatives, could vary between entities. The Board also believes that this alleviates possible uncertainty over what types of derivatives qualify for this election. Respondents to the Exposure Draft did not raise any concerns with this aspect of PSAB's approach.

Use of an accounting policy election

.14 While respondents generally supported the proposals introduced in the Exposure Draft, a small subset disagreed or felt that the use of an accounting policy election had not been demonstrated to be conceptually sound. A couple of respondents also indicated that the use of this election could cause inconsistencies or increase complexity in the financial statements. The Board, however, believes that the use of an accounting policy election in this instance is supportable. This is because the accounting presentation introduced by the election helps entities better reflect the risk management intent of their foreign currency hedging transactions in the financial statements.

.15 PSAB also notes that, while somewhat limited, accounting policy elections are evidenced in other areas of the PSA Handbook and used within other prominent international accounting standards. As an example, accounting policy elections are used within IFRS 9 *Financial Instruments* and International Public Sector Accounting Standards (IPSAS) 41 *Financial Instruments,* to provide entities with optionality on where to present fair value gains and losses on certain equity instruments. The Board further believes that the introduction of this election enhances comparability as it provides all public sector entities with the option to apply a similar accounting presentation as the federal government. As outlined below, required disclosures should afford users with clarity in cases where this election is made, thereby facilitating appropriate comparison between entities.

ACCOUNTING DISCLOSURES

.16 To improve transparency and comparability, PSAB has introduced disclosures in Section PS 3450 for those entities choosing to use this election. In these cases, an entity would have to disclose the carrying amounts of financial assets and financial liabilities at the financial statement date for which exchange gains and losses have been recognized directly in the statement of operations. This disclosure would be made by the financial asset or financial liability category as outlined in Section PS 3450. In line with the existing disclosure requirements in Section PS 2601, public sector entities are also required to disclose the exchange gains and losses recognized in the statement of operations and the statement of remeasurement gains and losses.

TRANSITIONAL PROVISIONS

Transition to the financial instruments' suite of standards

.17 PSAB has added guidance to the transitional provisions in Section PS 2601 and Section PS 3450 to clarify how this election is applied upon transition. Specifically, public sector entities could make this election for a financial asset or financial liability on transition to these standards. For those financial assets and financial liabilities where this election was made, any exchange gain or loss arising prior to or as at the transition date would be recognized in the accumulated surplus or deficit. This treatment would also apply to unamortized exchange gains and losses deferred on the statement of financial position.

Entities currently applying the financial instruments' suite of standards

.18 In response to feedback received on the Exposure Draft, PSAB has also introduced provisions which permit public sector entities that currently apply the financial instruments' suite of standards to make this election on their existing financial assets and financial liabilities. This provides these entities with the same opportunity to apply this election as those that have not yet transitioned to these standards.

.19 Guidance has been introduced in Section PS 2601 to indicate how these entities could apply this election. This outlines that this election must be made on a one-time basis at the beginning of an entity's fiscal year either on or before the final effective date of the financial instruments' suite of standards. This approach was used to prevent entities from applying this election at different times throughout a fiscal year based on the performance of their foreign currency transactions. This approach also ensures consistency with the application of the transitional provisions in Section PS 2601 and Section PS 3450.

.20 PSAB additionally considered how cumulative unrealized exchange gains and losses that exist at the date the election is made should be accounted for. It was concluded that these amounts should be recognized in the accumulated surplus or deficit. This approach is consistent with the transitional guidance introduced above and limits the fluctuation within surplus or deficit in the year the election is made.

.21 One respondent to the Exposure Draft raised concerns about the expansion of this election to entities currently applying the financial instruments' suite of standards. This was because instruments in a gain position could be cherry-picked for recognition in surplus or deficit in the year the election was made. Concerns were also raised that the use of an election to apply a different accounting treatment after transition to a standard may cause users to lose confidence in the financial statements.

.22 PSAB believes that the guidance established in Section PS 2601 mitigates these concerns. The recognition of cumulative unrealized exchange gains and losses in the accumulated surplus or deficit would prohibit the manipulation of surplus or deficit in the year of application. Required disclosures would also provide explanation and clarity to users of the financial statements in cases where this election was made. The Board believes that the expansion of this election is important so that all public sector entities have an equal opportunity to use this accounting treatment.

OTHER AMENDMENTS

.23 Consequential amendments have been made throughout Section PS 1201, Section PS 2601 and Section PS 3450 because of the introduction of this election. These amendments clarify the definition of remeasurement gains and losses and introduce related guidance for specific transactions.

.24 Most notably, PSAB has clarified the definition of remeasurement gains and losses to highlight that exchange gains and losses must be recognized in the statement of remeasurement gains and losses to qualify under this definition. Amounts subject to this election would not be considered remeasurement gains and losses as they would be recognized directly in the statement of operations.

OTHER MATTERS

.25 Some respondents to the Exposure Draft provided additional comments to PSAB relating to the volatility of measuring derivatives at fair value and the application of hedge accounting. The Board notes that the rationale for its previous conclusions on these matters is outlined in the Basis for Conclusions documents for Sections PS 2601 and PS 3450 published in July 2011.

.26 PSAB also received some feedback from respondents encouraging the Board to pursue a hedge accounting option to remove or mitigate volatility in net debt. This suggested option would involve not recognizing certain derivatives in the financial statements. The Board reviewed and deliberated this approach; however, it did not pursue this hedge accounting option. The Board noted that this would fundamentally differ from the hedge accounting models as seen for other publicly accountable entities, such as in IFRS® Standards and IPSAS, which would continue to require derivatives to be held at fair value. The Board believes that all derivatives should be recognized in the financial statements as this enhances transparency and accountability for users.
