

Financial Instruments — Basis for Conclusions

Section PS 3450

FOREWORD

CICA Public Sector Accounting Handbook Revisions Release No. 34, issued in June 2011, included a new standard, FINANCIAL INSTRUMENTS, Section PS 3450.

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 PSAB 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 followed by PSAB when developing the standards.

This document has been prepared by the staff of PSAB. This document does not form part of the CICA Public Sector Accounting (PSA) Handbook nor is it part of public sector generally accepted accounting principles (GAAP). 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 The Public Sector Accounting Board (PSAB) undertook this project to develop a new standard to improve the reporting of derivative and non-derivative financial instruments in financial statements prepared in accordance with the CICA Public Sector Accounting (PSA) Handbook. The new standard achieves this objective by requiring the recognition of derivatives and consistent reporting of their effect on financial measures, and by improving disclosures associated with financial instruments and financial risks.
- 2 The past decade has seen increased use of derivatives by public sector entities. A PSAB task force was convened in January 2005 within weeks of the approval by Accounting Standards Board (AcSB) of new financial instrument standards. Rather than debating whether the AcSB standard should apply to the public sector, the project enabled a discussion about requirements that should apply for public sector reporting. In its initial evaluation of the issues, PSAB asked for views on the following specific reporting issues:
 - (a) Do derivatives have the essential qualities of assets and liabilities?
 - (b) What is the most relevant basis of measurement for financial instruments?
 - (c) Should the statement of financial position include amounts other than assets or liabilities?
 - (d) Are there circumstances that merit a special accounting treatment for a hedging instruments?
- 3 Several due process documents were issued. The new standard is substantially based on an Exposure Draft, "Financial Instruments", issued in September 2009. Responses to the Exposure Draft led PSAB to propose amendments to FINANCIAL STATEMENT PRESENTATION, Section PS 1200. The amendments to Section PS 1200 were exposed in November 2010 together with the draft text of the financial instruments standard. A separate Basis for Conclusions has been issued that explains alternatives PSAB considered and conclusions behind its decision to issue FINANCIAL STATEMENT PRESENTATION, Section PS 1201.
- 4 Staff of PSAB undertook broad consultations to obtain comments on the Exposure Draft and the Statement of Principles that preceded it. The issues raised in those responses were extensively deliberated by PSAB over a number of meetings. Responses offered suggestions and expressed concerns. Some concerns related to aspects that are fundamental to the underlying principles adopted in this new standard. This document seeks to clarify the reasons specific principles were adopted and the adaptations made from amongst the broad range of alternatives PSAB evaluated.

PURPOSE AND SCOPE

- 5 The new standard applies to all public sector entities issuing general purpose financial statements prepared in accordance with the PSA Handbook. Its text applies a drafting convention that refers to entities applying the PSA Handbook as "governments". Within this document, the term "public sector entity" applies to all public sector entities using the PSA Handbook.
- 6 The new standard's scope of application is framed by definitions contained in the Glossary. A financial instrument is by definition a contractual arrangement between two or more parties. As such, the new standard does not apply to transactions that are not contractual in their nature, such as taxes, grants and transfers.
- 7 The definition of financial assets is consistent with FINANCIAL STATEMENT CONCEPTS, Section PS 1000. PSAB's reporting model is based on distinguishing between assets that are financial resources for a public sector entity and those that are non-financial. Financial assets are those that can be used to discharge existing liabilities or finance future operations and are not for consumption in the normal course of operations. Consequently, when a public sector entity reports on its financial assets, it includes items that may not be financial instruments. Inventories or items for resale that meet the criteria in FINANCIAL STATEMENT PRESENTATION, paragraph PS 1201.055, are financial assets but they are not financial instruments.

- 8 Paragraph PS 3450.003 sets out those financial assets and financial liabilities that are outside of the scope of the Section. In the case of certain types of contracts, other detailed standards are in place. For example, the new standard does not alter the reporting of loan guarantees and employer obligations associated with employee future benefits. In the case of leases, only those agreements containing embedded derivatives can be affected by this standard.
- 9 A national government may have certain assets or liabilities that are unique. The project scope did not include establishing new requirements for monetary gold, balances with the International Monetary Fund and liabilities arising from the issuance of currency or coinage. The accounting for these items may be addressed by the International Public Sector Accounting Board at some future date.
- 10 The accounting for specialized contracts related to insurance, climatic, geological or other physical variables was not part of the project scope. The new standard only applies when derivatives are embedded in such contracts or the contracts are exchange traded.
- 11 Given the length of the new standard, certain provisions that explain its application in greater detail were placed in Appendix A to Section PS 3450. Nonetheless, Appendix A is a primary source of GAAP.
- Guarantees**
- 12 Guarantees other than loan guarantees are outside of the scope of the standard. Unless a guarantee is in substance a derivative, it is accounted for in accordance with either LOAN GUARANTEES, Section PS 3310, or CONTINGENT LIABILITIES, Section PS 3300.
- RECOGNITION**
- 13 Comments were received that requirements to recognize derivatives and to measure financial instruments at fair value should not apply to sovereign governments due to fundamental differences attributable to their operations and authority. PSAB determined that a financial instrument has the same economic benefits and risks and is affected by financial market forces in the same manner, irrespective of the entity that holds or issues it. Accordingly, the new standard requires that financial instruments be reported on in a manner consistent with their attributes, rather than the attributes of the entity holding them.
- 14 Some respondents argued that governments always hold derivatives to maturity and asserted that as derivatives have no value at inception or at maturity they should not be recognized on the grounds that there are no future economic benefits obtained or given up.
- 15 It is understandable that some officials view derivatives as having no value on their own when it is their practice to use only derivatives that offer a "critical terms match" in relation to a hedged risk. In a document issued at an early stage in due process, PSAB proposed to adopt the hedge accounting methodology being applied by other publicly accountable entities in Canada. A number of respondents criticized provisions that would have required the reporting of ineffectiveness in hedging instruments that did not demonstrate a critical terms match. The Basis for Conclusions issued for FOREIGN CURRENCY TRANSLATION, Section PS 2601, addresses hedge accounting in greater detail.
- 16 The first due process document established that derivatives are assets and liabilities. 1 Respondents did not identify distinct differences in public sector risk management activities or the techniques used by their risk managers in comparison to profit-oriented entities engaged in managing similar risks. PSAB was not persuaded by arguments that derivatives have no value and are always held to maturity for several reasons:
- (a) In many cases, a derivative is acquired to offset a change in a price or rate at a specified future date or dates. At each date, one party is required to make a net financial settlement. Consequently, it is counter intuitive to state that derivatives have no value at maturity. 2
 - (b) From the date a derivative is struck, the parties control specific rights and obligations established in the contract.
 - (c) In nearly all circumstances, the value of those rights and obligations can be reliably measured at any point in time.
 - (d) Derivatives are not the same as executory contracts where the liability and the asset are established only when the other party fulfills its obligations.
 - (e) The government has the discretion to determine whether a risk should be hedged, whether that hedge is maintained or removed and its risk managers choose from amongst various hedging instruments. Not all risks are equally susceptible to hedging and less costly hedging strategies can lead to results that are not fully effective.
- 17 Some respondents asserted that by requiring the recognition of derivatives, PSAB would induce changes in behaviour with adverse consequences. Risks would no longer be hedged, potentially increasing borrowing costs and exposure to financial risks. Similar assertions have been made in responses to other standards proposals, where their adoption would affect the measure of annual surplus or deficit and net debt. Fundamentally, managers who select the strategies should report on and explain how execution of those strategies safeguards assets and manages risk.
- 18 Standard setters routinely consider the effects of adopting a new standard. Aspects of this assessment are intangible. We know that all other publicly accountable entities in Canada recognize derivatives. This is viewed as an important aspect of transparent reporting. While standards requiring the recognition of derivatives were the subject of broad-based

opposition when proposed, after five years, there is a degree of acceptance. Improvements continue to be worked on. It is notable that the use of derivatives continues to grow. On balance, a recognition standard is needed to ensure that public sector financial reporting has credibility.

- 19 To allay concerns about the volatility that measuring derivatives at fair value would bring to budget-to-actual comparisons, the Exposure Draft proposed gains and losses arising from the application of fair value measurement would be shown as remeasurement gains and losses. The Exposure Draft proposed that these gains and losses would be distinguished by presenting them within a second component of the statement of operations. Responses to this proposal were mixed. PSAB accepted the view that a statement of operations with two components could confuse readers or lead to conflicting assertions as to financial performance. Consequently, it concluded that there was a need to assess other alternatives.
- 20 The alternatives considered and the reasons PSAB amended its financial statement presentation requirements are explained in the Basis for Conclusions issued for FINANCIAL STATEMENT PRESENTATION, Section PS 1201. PSAB's decision balances concerns about volatility against the need to ensure public sector financial reporting is transparent and creditable. When fair value measurement applies and the related gains and losses are unrealized, the measure of operating surplus or deficit does not reflect this variability.

Embedded derivatives — identification and recognition

- 21 When a contract contains provisions equivalent to those found in a stand-alone derivative, the contract can give rise to future cash flows that are variable. This is described as a contract with an embedded derivative. Respondents supported the need to evaluate contracts for the existence of such provisions to maintain the integrity of the requirement to recognize derivatives.
- 22 The application requirements (paragraphs PS 3450.A18-A26) set out principles that determine when an embedded derivative is separately accounted for. The purpose is to limit the requirement to separately account for a derivative provision to situations where that provision is not closely related to its host instrument. Provisions that apply when transitioning to these requirements are described in the Transitional Provisions section of this document.
- 23 In many cases, the embedded derivatives typically found in debt instruments issued in the public sector will not need to be accounted for separately. For example, when debt is issued at par and the issuer retains the option to repay the debt at par, the debt instrument contains an embedded call feature that is clearly and closely related to its debt host. Similarly, when a debt instrument is issued at par and the investor has the option to redeem at par, this put option (provided by the issuer) is clearly and closely related to its debt host.

MEASUREMENT

On initial recognition

- 24 The new standard does not explicitly state a basis of measurement at initial recognition. Often, measurement at initial recognition is based on a market transaction. However, this is not always the case. For example, a portfolio investment or a loan receivable may have concessionary terms. When this is the case, the initial measurement value reflects requirements in PORTFOLIO INVESTMENTS, Section PS 3040, and LOANS RECEIVABLE, Section PS 3050.
- 25 Trade date accounting applies when publicly traded securities are acquired. Although standards for profit-oriented entities permit the use of settlement date accounting, it is not relevant to public sector reporting as governments are not subject to income tax. Recent changes to the Introduction to Public Sector Accounting Standards will significantly diminish the number of entities applying profit-oriented standards that governments will consolidate on a line-by-line basis. For these reasons, the benefits of conforming to one approach were viewed as outweighing the added complexity associated with alternatives.

Categories

- 26 The two measurement categories are straightforward and easy to understand. The default category is cost or amortized cost and applies to all items other than:
 - (a) derivatives;
 - (b) portfolio investments that are equity instruments quoted in an active market; and
 - (c) financial instruments included in the fair value category when the fair value option (paragraph PS 3450.023) is applied.
- 27 By reducing the need to actively designate items upon initial recognition, PSAB believes the new standard is highly scalable. Many public sector entities are small and do not hold derivative contracts. In this case, fair value measurement applies when these entities have portfolio investments that are equity instruments quoted in an active market. The information needed to report these items at fair value is readily available and verifiable. On the other hand, the public sector includes entities that manage and evaluate the investment performance based on fair value measurement. These entities have the option to base their accounting policies on fair value measurement.
- 28 A few respondents asserted that there should be broader application of fair value measurement. Some suggested that the approach adopted in the new standard is out of step with International Financial Reporting Standards and International Public Sector Accounting Standards, both of which require greater application of fair value based measures. Some asserted that PSAB did not make a convincing case for excluding non-equity financial instruments from fair value measurement. These positions were justified by a view that reliable and readily obtainable measurement information is available. It was asserted that broader adoption of fair value measurement would ensure that like items are measured in like ways.

- 29 Only a few of the respondents critical of the use of fair value measurement directly commented on the requirement to include equity instruments that are portfolio investments traded in an active market in the fair value category. Generally, those who addressed the measurement of these items agreed that fair value could apply when it is expected a gain or loss will be realized, based on the view that the proposal represents a reasonable compromise. Some offered that many governments probably do not have large portfolios of publicly listed equities.
- 30 Cost is not indicative of a future value or future cash flows associated with an equity instrument. A bond can be held to maturity but an equity instrument has no fixed date of maturity. Fair value provides users with better information about the resource that the equity instrument represents and the risk associated with holding it. For these reasons, fair value is an objective, consistent and comparable basis for measurement. By not requiring unquoted equity instruments to be included in the fair value category, PSAB is simply balancing the additional information provided against the time and trouble of valuing these items.

Transaction costs

- 31 Accounting for transaction costs depends on how the financial instrument is categorized. 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. For items in the cost or amortized cost category, transaction costs are part of an item's initial cost.

Fair value option

- 32 Many who supported the measurement approach supported the fair value option. Specific concerns were expressed that comparability between governments would be diminished. However, as public sector entities will inevitably vary in their approaches to managing financial instruments, establishing comparability was not a key objective. For example, many entities in the public sector do not invest in equity securities as their investment policies emphasize protecting principal. On the other hand, entities investing to achieve growth will find fair value based measures support comparisons that are more meaningful.
- 33 The fair value option is not an "item-by-item" designation. It can be applied when groups of financial assets, financial liabilities, or both, that are managed on a fair value basis according to a risk management or investment strategy. Avoiding an item by item designation upon initial recognition makes the standard easier to apply than standards that require an entity to actively designate items upon initial recognition.
- 34 The fair value option may be applied to unquoted equity instruments that are portfolio investments. It reflects the view that public sector entities should be able to report their portfolio investments at fair value when management and performance is on a fair value basis of measurement.

Effective interest method

- 35 Interest is recognized using the effective interest method. Some respondents suggested that the standard should allow public sector entities the flexibility to apply other methods. The effective interest method exactly discounts the estimated future cash payments or receipts throughout the life of a financial instrument.
- 36 While all requirements are subject to a materiality evaluation, the straight-line method can significantly overstate yield in the initial reporting period of a multi-period investment. This is illustrated in the example below.

Illustrative example: A public sector entity invests in a strip bond that pays \$5,000,000 upon maturity in five years. Its purchase price is \$3,917,500, which provides an effective yield to maturity of 5 percent. An investor in this type of security receives only the face value of the bond on maturity. An investment dealer has sold the stream of interest payments originally associated with the bond to other investors. As such, a strip bond trades at a discount to maturity based on its effective yield.

Year	Strip bond Effective interest method				Over (under) statement	Over (under) yield
		Yield	Straight-line	Yield		
0	3,917,500					
1	4,113,512	196,012	5.00%	216,500	5.53%	20,488 0.53%
2	4,319,188	205,676	5.00%	216,500	5.26%	10,824 0.26%
3	4,535,147	215,959	5.00%	216,500	5.01%	541 0.01%
4	4,761,905	226,758	5.00%	216,500	4.77%	(10,258) (0.23%)

5	5,000,000	<u>238,095</u>	5.00%	<u>216,500</u>	4.55%	(21,595)	(0.45%)
Total		<u>1,082,500</u>		<u>1,082,500</u>			

- 37 Representational faithfulness is enhanced when interest revenue and expense is measured based on the methodology used to manage fixed income instruments. To ease transition, carrying values and past results are not restated when the new standard is adopted.
- 38 Application of the effective interest method is addressed in paragraphs PS 3450.A41-A45. Application guidance addresses accounting for assets purchased at a discount, instruments with floating rate provisions and write-downs associated with impairment. Project scope did not include accounting for securitization arrangements as they were not viewed to be a reporting issue commonly encountered by public sector reporting entities.

Impairment of financial assets

- 39 The new standard requires that financial assets be assessed for impairment at each financial statement date. Financial assets may be assessed individually or in groups. This assessment extends to financial assets in the fair value category (other than derivatives) to ensure that the statement of operations includes any and all losses due to impairment.
- 40 The new standard does not establish new requirements that determine when impairment has occurred or how it is to be measured. The present requirements, which are based on identifying an other than temporary decline, are continued as Section PS 3450 refers to requirements in PORTFOLIO INVESTMENTS, Section PS 3040, and LOANS RECEIVABLE, Section PS 3050. Responses to a due process document early in the project indicated a general consensus that these provisions should continue to apply.

Reclassification

- 41 Given the classification model adopted and the manner in which the fair value option applies, reclassification of items should not occur frequently. When the fair value option is used, its application is disclosed in an accounting policy. Any change would be an accounting policy change and not a reclassification. The requirements in ACCOUNTING CHANGES, Section PS 2120, would apply.
- 42 The only circumstances that can give rise to a reclassification are when a quoted price in an active market is no longer available for an equity instrument that is a portfolio investment, or conversely, when a quoted price in an active market becomes available for an equity instrument that is a portfolio investment for which such a price was not previously available.

DERECOGNITION OF A FINANCIAL LIABILITY

- 43 The provisions governing derecognition of liabilities received considerable support in responses to the Exposure Draft. Those who disagreed with the adoption of these provisions cited issues associated with securities held by sinking funds and for debt management purposes.
- 44 Sinking funds may acquire an issuer's own debt securities for investment purposes. When sinking funds are established pursuant to an issuer's own legislation or policies, those funds are not externally restricted. RESTRICTED ASSETS AND REVENUES, paragraph PS 3100.04, defines the term "external restrictions" as stipulations imposed by an agreement with an external party, or through legislation of another government, that specify the purpose or purposes for which resources are to be used. Some respondents indicated they disagreed with the liability derecognition requirements because the purchase of a government's own securities by its sinking fund would need to be accounted for as an extinguishment. The implication is that the gross obligations of the issuer would be reduced and a gain or loss would need to be recognized.
- 45 In this respect, the new standard is not establishing new requirements as the elimination of inter-fund amounts is a present requirement. BASIC PRINCIPLES OF CONSOLIDATION, paragraph PS 2500.06, states: "Government financial statements should consolidate governmental units line-by-line on a uniform basis of accounting after eliminating inter-governmental unit transactions and balances."
- 46 It may be that LONG-TERM DEBT, paragraph PS 3230.22, has created a misunderstanding. The paragraph includes the requirement that a government disclose "the amount of a government's own securities purchased but not cancelled." However, this disclosure requirement should not be interpreted to override the general consolidation requirements. The requirement to disclose such holdings is not, in itself, contradictory with the line-by-line consolidation requirements.
- 47 As is generally the case, public sector entities are at liberty to enhance the disclosures they provide to explain the origin and purpose of their sinking funds. When they believe it to be relevant, they may include notes that reconcile their security holdings with amounts reported on the statement of financial position and clarify that in presenting a consolidated position, some debt instruments held in the sinking fund have been derecognized.
- 48 Certain debt securities trade in secondary markets as "strip bonds". In this case, an investor's only cash flow entitlement is to the principal when due. Alternatively, an investor may acquire only the interest coupons. An issuer that reacquires either instrument would derecognize the discounted value of that portion of the obligation that has been extinguished. In measuring the "cost" of the instrument reacquired, the discount rate would be that rate applied under the effective interest method for the security derecognized.

PRESENTATION

Remeasurement gains and losses

- 49 Presenting remeasurement gains and losses separately 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.
- 50 As a consequence, the statement of operations is not affected by the volatility that can arise due to fair value measurement. The approach strikes a balance as it improves the reporting of financial instruments while maintaining measures relevant to budget-to-actual comparisons. For a discussion of the alternatives evaluated and reasons PSAB adopted this approach, review the Basis for Conclusions for FINANCIAL STATEMENT PRESENTATION, Section PS 1201.
- 51 Upon derecognition of a financial instrument in the fair value category, a gain or loss is measured in relation to the item's cost or amortized cost and reported in the statement of operations. The remeasurement gains and losses reported in previous periods are reversed. Paragraph PS 3450.A47 provides an illustration.

Not-for-profit organizations

- 52 Government not-for-profit organizations, including those applying Sections PS 4200 to PS 4270, will adopt the new standard. The standard is effective on the same date for all government organizations.
- 53 It was suggested that not-for-profit organizations should have the option to report remeasurement gains and losses in the statement of operations. This option was asserted to be beneficial because it would enhance a comparison of the report of government not-for-profit organization with any peers that may use Part III of the CICA Handbook – Accounting. This option was not supported as it could diminish comparability amongst government organizations.

Offsetting of a financial asset and a financial liability

- 54 The new standard limits offsetting of a financial asset and a financial liability to situations where a legal right of offset is in place and the public sector entity intends either to settle on a net basis, or realize the asset and settle the liability simultaneously.
- 55 Those who disagreed with adopting this requirement 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 presentation to the users of financial statements. Those who have adopted this view, assert that it presents the substance of the transaction rather than its legal form.
- 56 Others who supported this same view asserted that the risk associated with credit events is nonexistent when reputable financial institutions are the derivative counterparties. However, recent economic events demonstrate that the credit ratings of derivative issuers can be subject to rapid and dramatic changes.
- 57 On balance, PSAB did not support developing an exception to the straightforward principle that limits offsetting. To adopt such an exception would require reaching a consensus on rules that would govern when the exception should apply. This adds complexity.
- 58 By limiting offsetting, users see the rights and obligations measured and reported on based on the underlying legal requirements of the contracts. This enhances representational faithfulness. Disclosures and financial statement discussion and analysis can be used to explain the risk management strategies in use and outcomes that are expected.

FINANCIAL STATEMENT DISCLOSURES

- 59 The financial statement disclosure requirements support the needs of users who wish to enhance their understanding of the public sector entity's use and holdings of financial instruments.
- 60 The focus is on providing further details when different bases of measurement apply within individual financial statement lines and other pertinent information that is not readily apparent.
- 61 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 new standard.
- 62 Key effects on the information users can expect to receive are outlined below:
- (a) Public sector entities explain the purpose they hold derivatives and their use in managing risk. These disclosures are presented in a manner that complements the risk disclosures.
 - (b) When valuation techniques are used, as is the case when unquoted items are measured at fair value, the methods used and key assumptions applied are disclosed.
 - (c) For items measured at fair value, a summary disclosure of the source of the information used to arrive at fair value is given. It is presented in the form of a three-level hierarchy in common use. Knowledgeable users are familiar with it. It assists users in understanding the sources of the underlying measurement data.
- 63 PSAB was asked to consider whether the disclosures should apply to small local public sector entities. The disclosures are already somewhat less than those that apply to publicly accountable entities in other sectors. As a result of applying a straightforward approach to the classification of items, the number of disclosures can be reduced. The new standard

does not require the disclosure of the fair value of items measured at cost or amortized cost. While the risk disclosures represent a significant new requirement, PSAB believes both large and small entities have financial statement users that seek information about the entity's financial instruments.

Risk disclosures

- 64 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 public sector entity at the reporting date.
- 65 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). This gives a public sector entity the flexibility to integrate a discussion of financial risk into a broader discussion of the risks it faces.
- 66 Both qualitative and quantitative analyses are required. The discussion portion focuses on financial risks arising from holdings of financial instruments. A public sector entity sets out its objectives, policies and processes to manage these risks, and explains changes that may have occurred since the last reporting period.
- 67 The quantitative analyses are organized according to the nature of the risk exposure. This includes credit risk, liquidity risk and the three forms of market risk (i.e., currency risk, interest rate risk and other price risk). When a public sector entity employs techniques that reflect interdependencies in risk variables, there is the option to disclose the market risk analysis in this manner.

OTHER MATTERS

- 68 Developing a principle to determine when financial assets are derecognized was not included in the project scope. This issue does not arise frequently in the public sector but may arise when a public sector entity enters into a pledged collateral repurchase agreement ("repos") in respect of traded securities it holds. Until PSAB addresses asset derecognition, public sector entities may wish to consider the recently released International Public Sector Accounting Standard (IPSAS) 29, *Recognition and Measurement of Financial Instruments*, in establishing an accounting policy. The standards of the International Public Sector Accounting Board are among the other sources of GAAP that public sector entities may choose to consider when a topic is not addressed in a primary source of GAAP identified in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section PS 1150.

TRANSITIONAL PROVISIONS

- 69 Unless transitional provisions specify otherwise, ACCOUNTING CHANGES, paragraph PS 2120.13, allows governments adopting new or revised PSA Handbook standards to apply them retroactively or prospectively. When a new accounting standard contains provisions that permit a choice, retrospective application can allow the benefit of hindsight. As the fair value option could be applied with hindsight, the transitional provisions do not allow for retrospective application. While retrospective restatement could have been required for other provisions, PSAB was mindful that these standards involve significant changes and it chose not to impose additional resource requirements that might delay implementation.
- 70 The transitional provisions that apply to the identification of embedded derivatives are quite flexible in their application. There is no requirement to retrospectively identify embedded derivatives. Each entity adopts and discloses the accounting policy it applies. These new requirements present public sector entities with the opportunity to align contract management and financial reporting functions on a go-forward basis.
- 71 Government organizations apply the new standard for fiscal periods beginning on or after April 1, 2012. Beginning in 2011, many government organizations will adopt the PSA Handbook as their primary source of GAAP. In nearly all cases, these organizations will transition from the CICA Handbook – Accounting. Consequently, these organizations are already applying standards that require the recognition of derivatives and the use of fair value measurement.
- 72 Government organizations preparing to adopt the PSA Handbook should take note of paragraph PS 3450.100. This paragraph applies when an organization adopts this new standard in the same period it prepares its first Public Sector Accounting Standards financial statements. The paragraph reiterates that the new standard is not applied retroactively and it directs that comparative amounts, including the opening statement of financial position, be presented in accordance with accounting policies applied by the government organization immediately preceding its adoption of Public Sector Accounting Standards. In this respect, transition to the new standard overrides provisions contained in FIRST-TIME ADOPTION BY GOVERNMENT ORGANIZATIONS, Section PS 2125.
- 73 In the case of governments, the new standard applies to fiscal years beginning on or after April 1, 2015. Governments are being provided with additional time to transition as the changes required of them are of greater consequence. In noting that a review will be undertaken by December 31, 2013, PSAB recognizes the international standards development activities on this topic and its own Concepts Underlying Financial Performance project may reveal concepts that the Board had not considered previously.

Footnotes

1. As stated in the March 2006 Statement of Principles, "Recognition and Measurement of Derivatives," derivatives qualify as assets and liabilities for the following reasons:
 - (a) The ability to settle a derivative in a gain position by receiving cash, another financial asset or a non-financial asset is evidence of a future economic benefit and is compelling evidence that the instrument is an asset.
 - (b) Similarly, the requirement to pay cash, transfer a financial asset, or a non-financial asset in settlement of a derivative in a loss position is evidence of a duty to sacrifice assets in the future and indicates that the instrument is a liability.
 - (c) The transaction or event giving rise to the government's control of the benefit, or conversely obligating the government, occurs upon execution of the contract to acquire the derivative financial instrument.
 2. A swap agreement comprised exclusively of a series of net settlements based on an interest rate differential at specific dates (i.e., an interest rate swap agreement) does not have any value upon its expiry other than that arising from the final settlement. Nevertheless, while the agreement is in force, it is an asset or a liability to each party, as depending on current rates of interest, it is either a resource or obligation. On the other hand, many other derivatives, such as cross-currency swaps, can give rise to significant net settlements on expiry.
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