

# Financial Instruments : Narrow-scope Amendments

## Section 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 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 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 (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 PSAB amended FINANCIAL INSTRUMENTS, Section PS 3450, in the CPA Canada PSA Handbook to change the treatment for bond repurchase transactions and clarify aspects of the Section's application and transitional provisions. The Board also amended LONG-TERM DEBT, Section PS 3230, in the PSA Handbook as a consequence of the amendments made to Section PS 3450.

### SCOPE

- .2 Stakeholders were concerned that Section PS 3450 establishes the accounting for receivables arising solely from legislation, such as receivables attributable to the Canada Pension Plan and Employment Insurance programs. A contract must underlie a financial instrument. Financial instruments are defined in the Section's glossary as "any contracts that give rise to financial assets of one entity and financial liabilities or equity instruments of another entity."
- .3 A receivable that arises from legislation is not a financial instrument. In this regard, paragraph PS 3450.003(a) states:  
This Section does not apply to:
  - (a) tax receivables and payables relating to taxes including payments-in-lieu of taxes.

- .4 PSAB determined that it would amend paragraph PS 3450.003(a) to specifically exclude receivables and payables not attributable to a contractual right or obligation. The Board expects this amendment to relieve this uncertainty.
- .5 A second amendment to the Section's scope of application addresses an error in drafting. PSAB removed paragraph PS 3450.003(e)(i). This clause is redundant because, Public Sector Guideline PSG-2, Leased Tangible Capital Assets, focuses on how a government lessee accounts for a lease liability associated with the lease of a tangible capital asset. PSG-2 does not address lessor accounting. A government lessee would not have a receivable under PSG-2.

#### **DERECOGNITION OF A FINANCIAL LIABILITY**

- .6 Since this Section was issued, stakeholders across Canada have expressed concern about the derecognition provisions where a government issues a debt instrument and then subsequently repurchases that instrument. This Section proposed to treat bond repurchase transactions as extinguishments. This would have resulted in recording a gain or loss upon repurchasing bonds from the open market and eliminating the financial asset and debt instrument in the reporting entity.
- .7 Stakeholders provided many reasons why a government repurchases its own debt from the market. Legally, the debt may not be cancelled when it is reacquired (debt is not legally defeased so payments continue to be made). Debt may be acquired and held to maturity for sinking fund purposes. It may be acquired and resold to the secondary market to provide market liquidity and to assist future debt issuances. Bond repurchases such as this may make the government bonds more marketable. By treating the repurchase of one's own bonds as an extinguishment resulting in a gain or loss, PSAB was told it may influence prudent operational decisions of governments across Canada.
- .8 In revising the treatment for a bond repurchase, PSAB deliberated how this would conflict with the definitions within its conceptual framework. To meet the definition of a financial asset or a liability, a government must have a claim against another party or an obligation to another party. When a reporting entity presents a liability for the debt and simultaneously presents an asset representing the acquisition of that debt from the open market, those two offsetting accounts would typically be eliminated upon consolidation (consistent with the BASIC PRINCIPLES OF CONSOLIDATION, Section PS 2500). By proposing that a repurchased bond would not be derecognized, the Board must justify this departure from its conceptual framework.
- .9 PSAB decided the departure was warranted. In Canada, governments may need to repurchase their own bonds for market and liquidity purposes, which is important to the public sector entity's access to credit through bond markets. There are benefits to preparers through the revised treatment of a bond repurchase. For many governments, repurchasing their own bonds can occur in high volumes. The specific amendments to the PSA Handbook reduce the administrative burden and cost associated with tracking these transactions.
- .10 Further, PSAB determined that while bond repurchases should not be treated as extinguishments unless legally extinguished, preparers are required to present the asset and liability on a net basis. In other words, the repurchased bond must offset the original liability. This minimizes the internal inconsistency within the PSA Handbook and addresses stakeholders' concerns. The new requirements are not intended to change the accounting treatment when an exchange of bonds results in a debt modification (paragraphs PS 3450.048-.049).
- .11 PSAB acknowledges that some stakeholders believe that governments should be permitted to record repurchased bonds as separate financial assets while at the same time showing the original liability on the financial statements (i.e., present both the asset and liability on a gross basis). They view the net presentation the Board proposed as problematic. If a government is holding its own bonds at the financial statement date, large portions of its outstanding debt may "disappear." However, the Board found overwhelming support for net presentation in response to the Exposure Draft and amended the accounting requirements accordingly.

#### **Intra-government bond holdings**

- .12 Some respondents stated that the amended bond repurchase treatment created inconsistencies with INVESTMENTS IN GOVERNMENT BUSINESS ENTERPRISES, paragraph PS 3070.37, which discusses "constructive" retirement of debt and related gains and losses. This may occur, for example, when a government organization purchases a bond that was issued by a government business enterprise from an outside entity.
- .13 The requirements of Section PS 3070 still apply for consolidation purposes. PSAB specifically targeted the situation where the issuer of a debt instrument repurchases that instrument and does not legally extinguish it. This was the narrow-scope issue stakeholders identified as imposing a large administrative burden due to high volume of such transactions.

#### **Offsetting requirements**

- .14 In response to the Exposure Draft, some stakeholders raised concerns that the net presentation of repurchased bonds could be confused with concepts in paragraph PS 3450.066. The paragraph refers to situations where offsetting is usually inappropriate. However, the technical (and legal) requirements to meet the criteria set out in paragraph PS 3450.059 (in particular, that the public sector entity "currently has a legally enforceable right to set off the recognized amounts") are a specific instance of where the right to set off a financial asset with a financial liability exists. These requirements do not apply to a repurchased bond that is not legally extinguished. In line with paragraph PS 3450.067A, it would be presented on a net basis on the financial statements.
- .15 There was some confusion with respect to an entity purchasing its own bonds for sinking fund purposes, in which case it may be offset (paragraph PS 3450.067A), versus other financial asset purchases in a sinking fund, which cannot be

offset (paragraph PS 3450.066(d)). The requirements to offset in paragraph PS 3450.067A only apply when a government repurchases its own bonds and has no plans for legal extinguishment. Offsetting in this specific case maintains some consistency with the principles of consolidation, which would have otherwise required elimination of a government's own bonds repurchased from the market.

#### **PRESENTATION**

- .16 PSAB clarified whether a transfer of collateral could be considered a net settlement. In June 2013, the International Swaps and Derivatives Association published a new Credit Support Annex (CSA). The CSA enables a standard approach to bilateral credit risk management in the over-the-counter derivatives market. It includes provisions requiring the transfer of collateral to mitigate credit risk. On, or promptly following a valuation date, a party with credit risk may demand the transfer of cash or securities to collateralize a derivative agreement. When a transfer occurs, the recipient obtains title to the collateral. The value of the collateral transferred forms part of the credit support balance. This is an amount the recipient retains unless the payor is entitled to a return of all or part of the credit support balance on a future valuation date.
- .17 These circumstances gave rise to uncertainty as the transfer of collateral could be considered a net settlement. This is not the intended outcome unless there is an extinguishment or modification in the underlying terms in the derivative agreement. When the terms in the derivative contract are unchanged, PSAB thinks that the transfer of collateral is a deposit. To clarify this, the Board added paragraph PS 3450.056A.

#### **TRANSITIONAL PROVISIONS**

- .18 Stakeholders asked PSAB to clarify how the transitional provisions apply in certain situations when it had originally issued the Section in 2011.

##### **Cost base used by controlling governments**

- .19 Canadian government not-for-profit organizations (GNFPOs) and other government organizations (OGOs) adopted Section PS 3450 in 2011. One of the challenges they experienced was determining the cost base to use upon transitioning to the standard from Part V of the CPA Canada Handbook – Accounting. Under Part V, equity instruments quoted in an active market were required to be fair-valued. For some of these organizations, changes in fair value were reported annually through the income statement.
- .20 To ensure that previously recorded changes in fair value were not reported in the annual operating results twice, entities adopted a new "deemed cost," which was the cost base on the first day of transition. This kept previously reported gains and losses separate from new ones related to the same financial instrument.
- .21 As a result, it may not be clear what cost base a controlling government should use for its government organizations upon consolidation. Some government organizations may be adopting the standards for the first time along with the government, in which case an item in the fair value category would require an adjustment to the opening accumulated statement of remeasurement gains and losses. Other entities, like the GNFPOs or OGOs, may have made an adjustment to their accumulated surplus or deficit when they adopted the standard. The standard has now been clarified to indicate that the controlling governments should consolidate these entities without having to adjust any of the underlying accounting policies of their various government organizations.
- .22 Some stakeholders asked PSAB to clarify the treatment of transaction costs associated with financial instruments on transition. Public sector entities had previously capitalized transaction costs as a part of a financial instrument's carrying amount, which was permitted under previous accounting standards. Paragraph PS 3450.099(a) states that measurement policies are not reversed. Capitalizing the transaction costs of a financial instrument constitutes a measurement accounting policy. Further, paragraph PS 3450.099(d) specifically prohibits any adjustment to an item's carrying amount to retroactively expense transaction costs. Therefore, carrying amounts should be maintained when transitioning to Section PS 3450, even where these amounts include capitalized transaction costs.

##### **Unamortized discounts or premiums associated with bond repurchases**

- .23 With the modification of the accounting to bond repurchases, a government would not have a transitional issue with unamortized discounts or premiums associated with past bond repurchases. The proposed treatment for bond repurchases has been clarified. Discounts and premiums should be accounted for as part of the liability balance of the debt and amortized over the remaining term of the debt issuance.

##### **Unamortized discounts, premiums or transaction costs associated with financial assets or financial liabilities**

- .24 A related question is how to account for an unamortized discount, premium or transaction cost associated with a financial asset or financial liability in the cost or amortized cost category on transition. The accounting can be at issue when the legacy accounting policy treats discounts, premiums or transaction costs as a separate asset or liability.
- .25 Discounts, premiums or transaction costs are included in the opening carrying value of the financial asset or financial liability. This approach is consistent with the treatment that applies when unamortized discounts, premiums or transaction costs have been in the carrying value of financial assets and financial liabilities.
- .26 PSAB also considered requiring any unamortized discounts, premiums or transaction costs be recorded in the statement of operations in the fiscal year Section PS 3450 is first applied. The Board rejected this as it diminishes comparability and because the amount is not a gain or loss attributable to the first post-implementation period.

## **MEASUREMENT OF DERIVATIVES**

- .27 Derivatives may not have been recognized or may not have been measured at fair value prior to adopting Section PS 3450. When this is the case, any difference between the previous carrying value and fair value is recognized in the opening balance of accumulated remeasurement gains and losses. This approach is consistent with the intent of paragraph PS 3450.099(b).

## **APPLYING THE REQUIREMENTS**

- .28 New guidance has been provided in Appendix A: Applying the Requirements. The new guidance explains that derecognition of a financial asset does not occur when the transferor of a financial asset retains substantially all the risks and benefits of ownership. The concept and examples are consistent with guidance included in International Public Sector Accounting Standard (IPSAS) 41, *Financial Instruments*. PSAB did not expect that adding this guidance would affect how entities that already apply Section PS 3450 account for a transfer of financial assets. Public sector entities may consult with the relevant IPSAS when considering an accounting policy on this topic.

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