Foreign Currency Translation — Basis for Conclusions

Section PS 2601

FOREWORD

CICA Public Sector Accounting Handbook Revisions Release No. 34, issued in June 2011, included FOREIGN CURRENCY TRANSLATION, Section PS 2601, which revises and replaces FOREIGN CURRENCY TRANSLATION, Section PS 2600.

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 a 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.

July 2011

BACKGROUND

1 Development of a standard to replace FOREIGN CURRENCY TRANSLATION, Section PS 2600, commenced in June 2006. As currency risk is a financial risk, efforts were coordinated with the financial instruments project.

2 The new standard is substantially based on an Exposure Draft), "Foreign Currency Translation," issued in October 2009. Responses to that Exposure Draft and the Exposure Draft, "Financial Instruments," issued in September 2009, were evaluated concurrently, and led PSAB to propose amendments to FINANCIAL STATEMENT PRESENTATION, Section PS 1200. When amendments to Section PS 1200 were exposed in November 2010, the draft text of this standard was posted. A separate Basis for Conclusions explains the reasons FINANCIAL STATEMENT PRESENTATION, Section PS 1201 was issued.

PURPOSE AND SCOPE

3 The new standard applies to all public sector entities issuing general purpose financial statements prepared in accordance with the CICA Public Sector Accounting (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.

4 There are two provisions in the approved text that were not present in the October 2009 Exposure Draft. The new standard does not apply to balances:

(a) derived from foreign exchange transactions intended to sustain foreign exchange reserves and orderly conditions in the foreign exchange market for the Canadian dollar or to provide assistance to foreign countries; and

(b) balances with the International Monetary Fund.

These provisions are consistent with scope restrictions in Section PS 2600. The provision excluding International Monetary Fund balances is also present in the new financial instruments standard.

ACCOUNTING

5 The new standard:

(a) eliminates the deferral of gains and losses arising on the translation of long-term monetary assets and liabilities; and

(b) requires gains and losses, on the translation of foreign denominated balances that have yet to be settled, to be reported as remeasurement gains and losses.

6 Some respondents cited the need to measure currency risk consistently and to report on the effects of changes in exchange rates. Others cited the benefit of a transparent representation of the performance of the risk management strategy.

7 Those opposed to eliminating the deferral of gains and losses on long-term monetary items expressed concern its withdrawal would lead to erratic swings in reported results that do not reflect the underlying economic substance of what is a long-term arrangement.

8 When a public sector entity chooses to issue a foreign denominated obligation rather than one repayable in Canadian dollars, it takes on currency risk. This decision should be evident to financial statement users. Management may choose to mitigate this risk or determine it will not do so. PSAB determined that financial statements should reflect the economic effects of this choice.

9 Those who favour continuing to defer gains and losses assert that it is unfair to use current rates of exchange to measure what is a long-term liability. Exchange rates can fluctuate dramatically and current rates may not be predictive of the final settlement amount. Deferral is preferred on grounds that it allocates the financial impact of currency risk over the future periods that will be affected. However, unlike amortization of a capital asset where a known amount is allocated to the future periods during which the asset will provide service, the financial effect of currency exposure is unknown.

10 For this reason, the deferral method can fail to diminish volatility. This is because in the period repayment is due, the denominator reverts to one and no further deferral is possible. Consequently, when the deferral model is applied to currency risk, it is simply that — a deferral of accountability for a risk the entity has knowingly assumed.

PRESENTATION

11 To allay concerns about the volatility that can arise when gains and losses on long-term monetary items denominated in a foreign currency are recognized, unrealized gains and losses associated with currency risk are distinguished in the financial statements. The Exposure Draft proposed presenting remeasurement gains and losses in a separate component within the statement of operations. However, support for a two-component statement of operations was mixed.

12 The new standard excludes all remeasurement gains and losses from the statement of operations. To enable this approach, PSAB exposed amendments now adopted in FINANCIAL STATEMENT PRESENTATION, Section PS 1201. Remeasurement gains and losses can also arise due to fair value measurement when required by FINANCIAL INSTRUMENTS, Section PS 3450. When a public sector entity adopts the new foreign currency translation standard, it also adopts Section PS 1201 and Section PS 3450. (For a detailed discussion of the alternatives considered and the reasons it adopted this presentation approach was adopted, see the Basis for Conclusions document for Section PS 1201.)

HEDGE ACCOUNTING

13 The hedge accounting provisions in Section PS 2600 have proven to be inadequate as current hedging activities are broad in their scope. Derivatives are used to manage a range of financial risk exposures in addition to currency risk.

14 When preparing summary financial statements, liabilities are normally grouped with other liabilities and similarly, assets are grouped with other assets. Another drawback of Section PS 2600 was that it allowed assets and liabilities in a hedging relationship to be grouped together when their exposure to currency risk is offsetting. This approach, known as synthetic instrument accounting, has been abandoned by other standard setters as it obscures information about the underlying hedging instrument and the hedging relationship. FINANCIAL INSTRUMENTS, Section PS 3450, severely limits offsetting.

15 The object of a hedging instrument is to offset changes in the value or cash flows associated with designated risk factor(s) in the hedged item. When changes attributable to the designated risk are fully offset, the hedging instrument is considered to be fully effective.

16 Reporting on the extent to which a hedging instrument is not fully effective, or ineffectiveness, has become an increasingly important financial reporting issue. If ineffectiveness is not evident, gains and losses can go unreported until the hedge is wound up or discontinued. In this regard, the requirements in Section PS 2600 were particularly weak. There were no requirements to explain how:

(a) hedging relationships are monitored for ineffectiveness;

(b) the gains or losses are recognized; and

(c) hedge accounting has affected the results being reported.

In absence of such requirements, the tendency may be to view all hedging relationships as fully effective.

17 Responses to due process documents and informal discussions with government managers indicated that certain public sector entities carefully structure hedging relationships in an effort to ensure that the hedging derivative matches the

critical terms associated with risks designated in the hedged item. 1 Others may use alternative strategies due to the amounts being hedged or to manage costs. While more sophisticated, these strategies are more likely to introduce a degree of ineffectiveness.

18 Reporting gains and losses attributable to the ineffectiveness of hedging instruments is not straightforward and continues to be controversial. Risk managers structure hedging relationships to perform over long time horizons, whereas users look to accountants to provide information that aligns with financial reporting cycles. Since short-term variations can and do arise when the individual items in hedging relationships are measured and reported on, the ineffectiveness recognized in one period may subsequently reverse. On the other hand, it can indicate that the hedging instrument is not performing as intended.

19 In many quarters, there continues to be significant interest in hedge accounting. This is in part because hedge accounting can be used to correct perceived "mismatches" in the timing of the recognition of gains and losses. In absence of hedge accounting, transactions to hedge interest rate risk on future debt issues may result in gains or losses being reported in operations prior to the interest expense being incurred. Some assert that this outcome reflects the change in the economic circumstances of the entity in a transparent manner. Others assert that hedge accounting is warranted to portray the strategy and its outcome. For the latter to be enabled, rules rather than principles are needed to guide in assessing the performance of the strategy selected by management and to establish when the usual principles that apply to the reporting of revenues and expenses are overridden.

20 Responses to an early due process document issued by PSAB indicated limited support for adopting the hedge accounting model applied by other sectors in Canada. This model is criticized as being arbitrary in relation to the hedging relationships it permits and for being complex in application. The International Accounting Standards Board (IASB) is progressing on its project to develop new hedge accounting provisions, but this work is not yet completed and aspects of the proposals are controversial. The International Public Sector Accounting Standards Board is expected to consider the applicability of conclusions reached by the IASB at a future date. PSAB is actively monitoring the IASB project and may choose to review this option at some future date.

21 Given the deficiencies in Section PS 2600, responses to due process documents issued during the financial instruments project, and the lack of consensus internationally on a hedge accounting model, PSAB has decided to adopt an approach that does not include hedge accounting.

22 PSAB favours this position because financial risk and its management are reported on in a transparent manner. It felt that the presentation approach it developed diminishes the need for hedge accounting as unrealized changes attributable to derivatives and currency risk do not affect annual operating surplus or deficit. Some key drawbacks associated with hedge accounting are avoided, such as the need for detailed guidance to support judgment and the complexity associated with recognizing hedge effectiveness.

23 PSAB recognizes that strategies that set out to hedge risks associated with anticipated transactions such as the rate of interest on a future debt issue and currency risk associated with expected purchases will not be accommodated without hedge accounting. Respondents cited this as a reason hedge accounting is needed. On balance, PSAB did not view the reasons cited for hedge accounting to be sufficiently compelling to justify the complexity involved.

OTHER MATTERS

24 Amendments to FIRST-TIME ADOPTION BY GOVERNMENT ORGANIZATIONS, Section PS 2125, were made to delete references to hedge accounting. Government organizations that adopt the PSA Handbook will discontinue hedge accounting in the period they adopt this new standard.

TRANSITIONAL PROVISIONS

25 Paragraph PS 2601.25 addresses specific circumstances entities transitioning from Section PS 2600 may encounter. All hedge accounting is discontinued on a prospective basis.

26 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 immediate recognition of gains and losses arising from currency risk. However, adoption of this standard will change the presentation of gains and losses.

27 Government organizations preparing to adopt the PSA Handbook should take note of paragraph PS 2601.26. 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.

28 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. A risk manager can be justified in presuming no ineffectiveness when the terms of the derivative offset all of the critical terms of the hedged risk. Generally, this requires that the net settlements specified are based on the same index or exchange rate and cover an equivalent notional amount, and each settlement occurs on the same date as the cash flows associated with the hedged risk. To achieve this objective, the derivative often needs to be customized as market-traded derivatives will rarely conform to each requirement.