

PUBLIC SECTOR ACCOUNTING DISCUSSION GROUP

Report on the Public Meeting

November 12, 2021

The Public Sector Accounting Discussion Group is a discussion forum only. The Group's purpose is to support the Public Sector Accounting Board (PSAB) by enabling discussion in a public venue of issues arising from the application of the CPA Canada Public Sector Accounting (PSA) Handbook, as well as emerging issues and issues on which PSAB requests advice. The Group comprises members with various backgrounds who participate as individuals in the discussion. Any views expressed in the public meeting do not necessarily represent the views of the organization to which a member belongs or the views of the Board. The discussions of the Group do not constitute official pronouncements or authoritative guidance.

This document has been prepared by staff and is based on discussions during the Group's meeting.

Comments made in relation to the application of the PSA Handbook do not purport to be conclusions about acceptable or unacceptable application of the PSA Handbook. Only PSAB can make such a determination.

ITEMS PRESENTED AND DISCUSSED

Section PS 3450: Embedded Derivatives in Own-use Contracts

FINANCIAL INSTRUMENTS, [Section PS 3450](#), is effective on April 1, 2022. The submission discussed the use of own-use contracts and if such contracts are required to be assessed to identify and recognize embedded derivatives.

Issue

The interpretation of Section PS 3450 has led to diverging views with respect to applying the standard. The submitter introduced the following two aspects of the standard that cause diverging views:

- An embedded derivative is a component of a non-derivative host contract which has cash flows that vary in a way similar to a stand-alone derivative. An embedded derivative can cause some or all of the cash flows required by the host contract to be modified in accordance with another variable, such as a specified interest rate, a financial instrument price, a foreign exchange rate or a credit rating. [Paragraph PS 3450.014](#) requires entities to identify host contracts that contain embedded derivatives and apply [paragraphs PS 3450.A18-A26](#) to determine if they are to be recognized.
- The term "own-use contracts" refers to contracts that meet the own-use exemption to buy or sell non-financial items that reflect quantities that are in accordance with a public sector entity's expected purchase, sale or usage requirements. These contracts are scoped out of the standard in [paragraph PS 3450.003\(p\)](#).

The Group was asked to consider two views on whether an own-use contract is required to be assessed to identify and recognize embedded derivatives:

- A. An own-use contract is not required to be assessed to identify and recognize embedded derivatives.
- B. An own-use contract *is* required to be assessed to identify and recognize embedded derivatives.

The reasons for the submission were:

- request further clarity in the wording of the standard given the divergence in views;
- determine if recognition is required given the significant amount of work involved in reviewing contracts;
- express concern over prudent use of public funds in complying with the standard; and
- clarify or confirm PSAB's intent in developing the standard.

Several Group members noted that, while they agreed with View A, the standard's wording is not explicit, or text in the related Basis for Conclusions confuses the requirements. The Group members further noted that PSAB should consider clarifying its intent with respect to identifying embedded derivatives in the standard.

Many Group members noted the scoping logic in [Section PS 3450](#) is clear; once an item is scoped out in early paragraphs, it is not reintroduced into the scope later. One Group member also noted that such scoping logic is consistent with other standards (e.g., GOVERNMENT TRANSFERS, [Section PS 3410](#)) and works well.

One Group member said steps can be taken to limit the amount of work in reviewing contracts to assess compliance with the standard. Pragmatically, create a strategy to identify material own-use contracts and recognize any embedded derivatives therein that fall within the scope of the standard. Other Group members agreed, noting professional judgment would be applied in determining the contracts to examine and best practices should be developed to evaluate contracts for embedded derivatives. Another suggestion was that standardizing contracts can also reduce the time and effort required to identify instances when an embedded derivative may be included in a contract.

Another Group member noted the bulk of the work in reviewing contracts would be done in the year leading up to adopting the standards. From that point on, contracts should be reviewed at their inception and assessed regularly. Internal controls can be implemented to determine and track the use of embedded derivatives in contracts.

Most Group members noted that evaluating contracts is an exercise in proper risk management. Contracts that may contain terms and conditions posing a material risk to a public sector entity are relevant to stakeholders and should be disclosed.

Group members who supported View B noted:

- It is a safer approach to review all contracts.
- There is a significant amount of work involved in reviewing contracts that may not have material embedded derivatives or pose a risk.
- It is difficult to estimate, and perhaps justify as a prudent use of public funds, the costs and efforts involved in reviewing all contracts.
- View B is more consistent with good governance and risk management. It is hard to know the extent of risks without doing the work. Alternatively, are there other more probable and material risks that would be missed if limited public resources are dedicated to reviewing all own-use contracts for embedded derivatives?

Group members could not reach a consensus on View A and View B. However, in most instances, those supporting either view noted additional clarity of intent may be required from PSAB.

One Group member noted that undoubtedly PSAB and its task force took considerable time and effort in setting out the requirements of the standard. The Group member thought the wording in the standard is clear and View A should be applied. There should be no need for immediate change in the standard. They thought concerns expressed in the submission do not warrant the Board making significant amendments or re-exposing the standard. Given how long it took to adopt the standard, any amendments should be considered as part of a post-implementation review. The Group member thought Section PS 3450 is a complex standard and advised caution in recommending any modifications, as any changes may introduce further complexities and delays in implementing the standard.

A Group member noted when the task force was developing paragraphs 21-22 for the Basis for Conclusions, it likely had ideas of what potential exceptions or exclusions may be. If some embedded derivatives would potentially be missed if one accepts View A as the correct approach, then additional guidance would be needed from PSAB to clarify its intent.

A Group member said smaller public sector entities, such as smaller municipalities, are very unlikely to have embedded derivatives within their contracts. Another Group member noted it would be interesting to consider what is being done across jurisdictions and levels of government in adopting this standard. Examples of material instances of own-use contracts containing an embedded derivative would be helpful.

One Group member said that the wording used in [Section PS 3450](#) is similar to that used in International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*. They cited [paragraph PS 3450.A26\(d\)](#) as an example. The Group member noted that foreign currency risk exposure could be placed as an embedded derivative in a host contract. However, the host contract would not be defined as a financial instrument and, therefore, the host contract itself would not be in scope of Section PS 3450. What is intended to be scoped out:

- the host contract only; or

- the host contract and any embedded derivative contained within the host contract?

Although some Group members supported View B, they mentioned various considerations and issues, such as:

- Cost-benefit: Concerns about the costs versus the benefits of a full review of contracts;
- Relevance: There may be few occurrences of embedded derivatives in own-use contracts;
- Materiality: Developing appropriate guidelines and thresholds as a strategy to review contracts;
- Professional judgment: Still required when determining to adopt the standard; and
- Intent: Clearer understanding of the objective related to identifying embedded derivatives in own-use contracts in adopting the standard

One Group member noted there is merit in assessing contracts not only from the perspective of Section PS 3450 but also in performing additional due diligence to identify and to potentially recognize unreported assets or liabilities. The Group member explained that in leading up to adopting LIABILITY FOR CONTAMINATED SITES, [Section PS 3260](#), and ASSET RETIREMENT OBLIGATIONS, [Section PS 3280](#), their organization completed the due diligence required and found items that were not recognized.

Ultimately, regardless of their preferred view, most Group members acknowledged additional clarity would be beneficial. Many requested PSAB assess ways to resolve the divergent views by providing such clarity. It would help stakeholders determine the efforts required to comply with the standard.

Financial Reporting of Natural Capital

The submission asked the Group to discuss public sector entities' financial reporting of natural capital. The submission was prepared by Group member Robert Siddall and other experts involved in reporting natural capital and sustainability:

- Joanna Eyquem, Managing Director, Climate-Resilient Infrastructure, Director of Quebec Programs, Intact Centre on Climate Adaptation, Faculty of Environment, University of Waterloo;
- Roy Brooke, Executive Director, Municipal Natural Assets Initiative and Principal, Brooke & Associates;
- Bailey Church, Partner and Leader of National Public Sector Accounting Advisory Services - KPMG;
- Michelle Molnar, Technical Director of the Municipal Natural Assets Initiative, CPA Canada and Environmental Economist and Policy Analyst, David Suzuki Foundation; and
- Ece Ozdemiroglu, Founding Director, Economics for the Environment Consultancy.

The Group was asked to discuss what the public and its elected representatives need to know about the natural capital of a public sector entity in order to hold it accountable for the management, use,

maintenance, growth, depletion or disposition of the natural capital for which it is responsible. The Group was asked to discuss:

1. What aspects of this information about natural capital can be presented in financial statements?
2. What aspects of this information about natural capital is better presented in reports other than financial statements? What form should the reports take: part of an existing report (e.g., FSD&A¹ or a Performance Report²) or a new report?
3. What other key factors may need to be considered when integrating natural capital into financial reports?

Issues

The submission provided Group members with background materials to consider, as the concept of accounting for natural capital is an emerging issue. The following was introduced as preamble to the discussion:

- The Canadian context in relation to natural capital: specifically, the significant wealth of natural capital held across Canada in the public sector.
- A generally accepted idea in financial reporting that “what gets measured, gets managed”: This was noted in support of the need to inventory, value, and monitor natural capital so it is considered in decision-making and public sector entities can be held accountable for its use, sale, depletion, etc.
- Why now? It was noted that the public sector could help mitigate climate change by investing in natural capital, especially green infrastructure that provides ecosystem benefits in addition to its structural functionality.
- The road ahead: Significant work needs to be done to establish standards that include natural capital and consider its biodiversity and ecosystem benefits, not just its extraction value.

The Group first discussed what information about natural capital can be reported in financial statements. Overall, many Group members concluded that a measured approach and gradual integration of natural capital into financial reporting would be essential.

One Group member noted governments at different levels may share responsibility for ensuring the sustainability of natural capital. Some governments are currently working on accounting for natural capital. Governments may be seen to have an obligation to maintain the natural capital in their jurisdictions. However, the balance between economic development and environmental stewardship remains a challenge.

¹ FSD&A (Financial Statement Discussion and Analysis), general guidelines for which are set out in Statement of Recommended Practice (SORP) 1, *Financial Statement Discussion & Analysis*. SORPs are not part of GAAP. They provide general guidance on reporting outside of financial statements and may be useful when public sector entities choose to prepare such reports.

² SORP-2, *Public Performance Reporting*, sets out general guidelines for preparing performance reports.

Most Group members noted the standard-setting process is lengthy. Specifically, they recognized it would be appropriate to begin working toward the reporting of natural capital on a timely basis. One of the submitters detailed various efforts undertaken in other jurisdictions such as:

- progress is being made in the United Kingdom to issue guidelines, best practices and standards;^{3,4}
- research and improved data and analytics in inventorying and measuring natural capital;
- improved asset-management systems and technology facilitating timely reporting of natural capital;
- additional efforts of various standard setters and policy makers integrating natural capital into financial reporting.

Many Group members questioned what type of information would be contemplated for reporting natural capital in financial statements. One Group member mentioned that certain aspects of the environment and its ecosystems provide an intrinsic value for which measurement may be difficult or not possible.

One Group member explained that natural capital may have different meanings and values to different individuals and public sector entities. Three Group members explicitly acknowledged the importance of involving Indigenous communities in developing financial reporting requirements for natural capital. Natural capital is very important to Indigenous peoples given their traditional stewardship of the lands and waters. The lands and waters have cultural significance for Indigenous communities and impact their financial and physical sustainability. A Group member noted the following from an Indigenous perspective:

- What can be classified as an asset by a public sector entity may be impacted by Indigenous land claims, treaties, etc. Such legal questions could affect whether natural capital is considered controlled by a government or other public sector entity currently considered to have “inherited” the lands of which the natural capital is a part. Contingent liabilities related to such claims may arise for that government or other public sector entity in relation to such lands.
- Ownership and control of certain types of assets, such as Crown land, would need to be assessed to consider such legal contingencies. Control over natural capital on reserve lands is also an issue to be considered.
- The impact of climate change on their ancestral way of life is significant for Indigenous communities.
- The economic value of natural capital goes far beyond its extraction value. Natural capital has qualitative values: biodiversity, a healthy environment, mitigation of environmental events, foundation of Indigenous cultures, etc. Several Group members shared this view.

³ Natural Capital Account for Northern London Borough of Barnet:

<https://barnet.moderngov.co.uk/documents/s40941/Appendix%20%20Natural%20Capital%20Account%20for%20Barnet.pdf>

⁴ Guide for Natural Capital of Great Manchester: <https://www.greatermanchester-ca.gov.uk/what-we-do/environment/natural-environment/natural-capital/natural-capital-user-guide/>

- One Group member suggested broader engagement with Indigenous peoples in developing standards relating to natural capital. Another Group member suggested PSAB use Indigenous knowledge in establishing standards for natural capital and that Indigenous communities should be partners in establishing any requirements. Given the importance of natural capital to their world view, Indigenous perspectives would be critical in understanding the value of natural capital beyond its extraction value. A holistic approach makes sense for natural capital, including consideration of subsoil resources, the air above lands, the interconnectedness of types of natural capital, and the nature of inter-related ecosystem and biodiversity benefits natural capital provides.

A Group member noted it would be important to determine the following prior to having wider discussions about financial reporting of natural capital:

- What are the objectives of holding the natural capital? These objectives could be disclosed in financial statements. They would provide important context for decision-making in relation to natural capital held and may have implications for reporting natural capital in financial statements. If the purpose for holding natural capital is not achieved, would there be any obligations that are liabilities for the relevant public sector entity? For example, would liabilities be created if there are violations of contracts or government commitments? Or would there be social impacts created that give rise to obligations if natural capital held is not managed to achieve objectives?

Several Group members expressed concerns with integration of the reporting required, such as:

- Consistent presentation and measurement within public sector entities' financial statements would be important for user understandability.
- Measuring, verifying, and monitoring natural capital will be challenging, and audit issues may also arise.
- Consider key commitments of Canada and note contributions required to achieve them from different levels of government; will meeting or not meeting them have financial statement implications?

One Group member questioned whether natural capital should be reported in financial statements, as their focus is fiscal rather than environmental. A separate report was suggested as an alternative, given that most natural capital information would be qualitative. The Group member continued, noting that governments operate with a different mindset:

- Governments operate on a cash and revenue/spending basis and focus on achieving a balanced budget.
- Public sector financial statements largely reflect items at historical cost. A market-based approach that takes into account costs and benefits would likely better reflect the value of natural capital, especially natural capital not acquired through an exchange transaction and for which a transaction price is unavailable.

Several Group members expressed concern that current financial statements cannot adequately report natural capital because quantitative value information would be insufficient, especially if focused on extraction value alone or if there is no initial investment cost. The value of natural capital may also vary depending on its location. Measurement attributes and approaches the International Public Sector Accounting Standards Board (IPSASB) is considering for heritage assets may provide a way to look at natural capital. Qualitative information explaining what any value reported represents would be important given the distinctiveness of natural capital.

The submitters mentioned that PSAB and chartered professional accountants (CPAs) in the public sector are best positioned to facilitate financial reporting of natural capital. They noted accountants speak the same language as chief financial officers (CFOs) and are trusted to make sure information reported is credible and unbiased.

The submitters shared their expertise and knowledge with the Group in relation to inventorying and valuing natural capital. They suggested disclosures should make clear what is included in reported values and what is not. They noted visibility of natural capital is crucial for managing it and considering it in decision-making and replacing a zero value with any value, even an imperfectly calculated amount, provides improved transparency. The submitters provided examples of current international initiatives to show that inventorying and valuing natural capital for financial reporting purposes does not present insurmountable issues. These examples can form a starting point for public sector entities. Work has already been done that can be leveraged, including the United Nations' [Natural Capital Accounting and Valuation of Ecosystems Services](#) project.

Group members shared the following:

- Measuring the social return on investment in ecosystems is difficult.
- Reporting of any value, even if nominal, is better than zero as it provides a starting point and some visibility. Invisible resources (e.g., CO2 levels and ecosystems) can be sold or depleted without accountability. Reporting of natural capital may also encourage decision-makers to invest in “nature-based solutions,” including green infrastructure with its inherent climate mitigation and ecosystem benefits, rather than manufactured, single-function “grey” infrastructure (e.g., dams and reservoirs).
- In completing an inventory of natural capital, identifying monetary values may need to be a second step. First, public sector entities would develop a detailed inventory. Second, they would disclose the nature and extent of major types of natural capital in financial statements or other reports. Third, they would be reporting on the condition of the natural capital. This reporting, similar to reporting on infrastructure deficits, is likely most appropriate outside of financial statements.⁵
- Concerns were expressed about completeness of information on natural capital. A question was raised as to whether an incremental approach to disclosures by type of natural capital is possible.

⁵ As an example, see SORP-3, *Assessment of Tangible Capital Assets*.

- A big unknown is what initial investment may be required to complete an inventory of natural capital. Further, the costs may be incurred in the short term but the benefits for decision-making, accountability and sustainability would be realized over the long term. Benefits of climate-change mitigation related to management of natural capital may be realized in the shorter term.
- The focus needs to be on progress as opposed to perfection.
- Asset-management systems are beginning to measure and monitor aspects of natural capital. Initially, perhaps asset-management reports rather than financial statements might present natural capital, though requiring this is beyond PSAB's authority to mandate. Financial reporting standards could then build on this asset-management work.

One Group member commented it would prove next to impossible to rationalize the meaning of dollar values for natural capital. Another Group member argued the overall objective should be to try as best as is possible to make the invisible become visible. Accountants may be initially uncomfortable with measuring new items in new ways, and reliance on specialists, as is done for other financial statement items, may be required. It was suggested that since international sustainability standards will be initially focused on the private sector, public sector sustainability reporting is an area where Canada could lead. Another Group member noted there remains the challenge of attempting to quantify items that do not have a direct economic use, or benefits that can easily be translated to a financial statement value that is auditable.

A Group member responded that the possibility of reporting natural capital in financial statements should not be dismissed as impossible given efforts underway in Canada and elsewhere to inventory and measure some types of natural capital. A decision-tree approach could be used to filter down to types of natural capital that

- meet the asset definition and can be measured and recognized in financial statements;
- qualify only for disclosure; and
- need to be reported outside of financial statements while work is undertaken to develop information that would make them capable of financial statement disclosure or recognition.

The Group member added that such an approach could normalize and socialize non-financial reporting of natural capital, including disclosure of cost-avoidance and other benefits of managing natural capital. Another Group member commented that MEASUREMENT UNCERTAINTY, [Section PS 2130](#), may provide useful guidance for developing natural capital disclosures.

Many Group members contemplated approaches to measuring natural capital. While views and approaches differed, the following were raised:

- Just because natural capital items are unique, this does not mean their value cannot be reasonably estimated. The example of heritage assets was again referenced.

- Natural capital comprises many potential assets. Each category is distinct and may need different measurement techniques to estimate value.
- Completeness will never be entirely achieved given the evolving nature and ongoing depletion of natural capital, but this reality should not deter entities from making assumptions to establish reasonable estimates of the value of natural capital.
- Both financial costs to maintain natural capital and financial benefits derived from what an entity would forego by protecting them can be shown in monetary terms.
- Transparency is key. It is important to show all accountability information including the data and the assumptions made in compiling an inventory of the nature and extent of types of natural capital and in assigning value to them. Details should clarify what is included and excluded for valuation purposes, as well as descriptions of what was not measured.
- Performance reports may prove helpful in measuring achievement against climate-related commitments.

Many Group members did not agree on whether natural capital should be reported in financial statements. However, most agreed that some form of reporting of natural capital is needed. They noted the following:

- The CPA's role is to report relevant information to decision-makers.
- PSAB should use the work from the IPSASB's Natural Resources project to the extent possible and appropriate for Canada, as long as the focus is on more than extraction value. PSAB monitors IPSASB's work and contemplates the impacts and adoption on a project-by-project basis. It will be important to continue to monitor IPSASB's work on natural capital in order to leverage and monitor how this may be applied to Canada.
- PSAB should emphasize what natural capital is currently allowed to be recognized under existing standards if it meets the asset definition and the general recognition criteria.
- Nature is complex. Its various aspects and ecosystems are interdependent, including humans, whose existence ultimately depends on nature. Separate reporting may be required to provide stakeholders with sufficient relevant information about this critical type of capital.
- Financial statements are important tools to foster stakeholder engagement. With climate-related topics being so critical, presenting some information about natural capital, including investments in green infrastructure, in public sector financial statements will assume greater importance for citizens.

Most Group members agreed CPAs have a vital role to play in having natural capital included in financial reporting for the following reasons:

- The International Sustainability Standards Board announced it will have an office in Montreal. This places Canada in the spotlight and gives the public sector and PSAB an opportunity to collaborate.

- If CPAs do not get involved, someone else will. Other professionals, such as environmentalists, economists, and engineers, may take the lead on this subject as climate-related reporting is moving forward with or without CPAs.
- CPAs converse with CFOs and stakeholders. CPAs can lead discussions with decision-makers on the importance and significance of accounting for natural capital.
- CPAs are deeply involved in standard setting and can assist in establishing guidance and standards.

Most Group members agreed some form of reporting of natural capital would be important for PSAB to consider, some members indicating it as a key priority for the Board. And many Group members agreed CPAs have the skills to make a difference in the reporting and management of natural capital. However, Group members differed in their views on the format, presentation, measurement and other considerations relating to reporting natural capital.

In conclusion, the Chair appreciated the comprehensive discussion, acknowledged its importance as a basis for PSAB's future work, and summarized some takeaways from the discussion:

- Group members agreed that inventorying natural capital would be the right first step.
- Some types of natural capital are more likely to meet the asset definition than others. Crown lands are an example of a more complex issue.
- Liabilities related to natural capital and government commitments on sustainability are possible.
- Under current generally accepted accounting principles (GAAP), incorporating natural capital in financial statements may be difficult because existing measurement attributes may not adequately capture some benefits associated with natural capital.
- PSAB could consider removing the recognition prohibition relating to inherited natural resources to allow experimentation with applying existing principles to all types of natural capital. Reference to current examples where reporting or disclosures of natural capital has been done might help in this regard. The Board could consider allowing an incremental approach to disclosures to foster such experimentation.
- Disclosure is a good first step but may provide less accountability than financial statement recognition would for the use, disposition or depletion of natural capital. The primary financial statements are perceived to carry more weight than note disclosures.
- PSAB should consider the perspectives of Indigenous peoples in developing recommendations for reporting natural capital. Perhaps for this particular issue a partnership approach would be more inclusive than the traditional consultation approach of exposing proposals for comment and encouraging Indigenous governments to input.
- Consider filters for assessing what information can be recognized or disclosed in financial statements and what might be better suited to reporting outside financial statements.

- Reliance on specialists would likely be required both for preparing reports that include natural capital and for auditing any information reported or disclosed in financial reports.
- There is a value to reporting quantified information in driving scrutiny and action; the invisible becomes more visible and is considered in decision-making.
- PSAB should leverage the work from IPSASB's Natural Resource project to the extent it meets the needs of Canadian stakeholders.
- A majority of Group members agreed the Board should consider including this topic in its next project-priority survey to determine its priority with stakeholders.

The submitters closed by asking PSAB and CPAs in the public sector to be at the table to facilitate financial reporting of natural capital. They noted accountants speak the same language as CFOs and are trusted to make sure information reported is credible and unbiased.