

## Section PS 3450: Embedded Derivatives in Own-use Contracts

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### Extract, PSA Discussion Group Report on the Public Meeting – November 12, 2021

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 undoubtably 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.