PSAB

Public Sector
Accounting Board

Exposure Draft and Basis for Conclusions

FINANCIAL INSTRUMENTS – NARROW-SCOPE AMENDMENTS

January 2019

COMMENTS TO PSAB MUST BE RECEIVED BY
May 1, 2019

An online response form, linked to this document, has been provided to assist you in submitting your comments to PSAB. Alternatively, you may send comments via email (in Word format), to:
info@psabcanada.ca addressed to:

Michael Puskaric, CPA, CMA
Director, Public Sector Accounting
Public Sector Accounting Board
277 Wellington Street West
Toronto ON M5V 3H2

This Exposure Draft reflects proposals made by the Public Sector Accounting Board (PSAB).

Individuals, governments and organizations are invited to send written comments on the Exposure Draft proposals. Comments are requested from those who agree with the Exposure Draft as well as from those who do not.

Comments are most helpful if they relate to a specific paragraph or group of paragraphs. Any comments that express disagreement with the proposals in the Exposure Draft should clearly explain the problem and include a suggested alternative, supported by specific reasoning. All comments PSAB receives will be available on the website shortly after the comment deadline, unless confidentiality is requested. The request for confidentiality must be stated explicitly within the response.

Highlights

The Public Sector Accounting Board (PSAB) proposes, subject to comments received following exposure, to amend FINANCIAL INSTRUMENTS, Section PS 3450, in the CPA Canada Public Sector (PSA) Accounting Handbook.

The Basis for Conclusions, which accompanies this Exposure Draft, addresses alternative views and the Board position, with its reasons.

Main features of the Exposure Draft

Narrow-scope amendments are being proposed to:

- change the accounting treatment for debt buybacks;
- clarify aspects of the Section's application; and
- add new guidance to the transitional provisions.

Debt buybacks (or bond repurchase transactions)

The most substantive issue addressed in this Exposure Draft is the treatment for debt buybacks. The standard currently states that when a government issues a debt instrument then acquires that debt instrument from the secondary market, that transaction would be treated as an extinguishment. The Exposure Draft proposes that such bond repurchase transactions not be treated as an extinguishment, unless they meet the criteria set out in paragraph PS 3450.043 (legally discharged) or paragraph PS 3450.048 (exchange of debt).

Purpose and scope

Two amendments are proposed:

- Unless a contractual right or a contractual obligation underlies a receivable or payable, Section PS 3450 does not apply. By definition, there must be a contract for there to be a financial instrument.
- Paragraph PS 3450.003(e)(i) is removed because it is redundant. The clause is redundant because LEASED TANGIBLE CAPITAL ASSETS, PSG-2, focuses on how a government lessee accounts for a lease liability associated with the lease of a tangible capital asset. A government lessee would not have a receivable under PSG 2.

Presentation

A new paragraph clarifies how a transfer of collateral pursuant to a credit risk management mechanism in a derivative contract is accounted for.

Transitional provisions

Three clarifications are proposed:

- Clarify that a controlling government would use carrying values of the financial assets and liabilities in the records of its government organizations when consolidating a government organization.
- Financial assets or financial liabilities in the cost or amortized cost category may have an associated unamortized discount or premium. When this is the case, the discount or premium is included in the item's opening carrying value.

- 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.

Applying the requirements

- Appendix A is amended to include guidance explaining that derecognition of a financial asset does not occur if the transferor of a financial asset retains substantially all the risks and benefits of ownership.

Implications of the proposals

The proposed revision to the treatment of debt buybacks will affect how the annual surplus/deficit is calculated. This is because transactions that previously would have been considered extinguishments will no longer be treated as such. This will also affect the presentation of assets and liabilities on the balance sheet. It will not affect net debt.

Other amendments to the standard are considered improvements to its wording and clarify the existing pronouncements:

- The amendment to paragraph PS 3450.003(a) responds to a request to clarify that Section PS 3450 does not apply to receivables and payables that are not contractual in their origin, such as those associated with contributions to the Canada Pension Plan and Employment Insurance programs.
- The removal of paragraph PS 3450.03(e)(i) eliminates a redundant clause.
- Paragraph PS 3450.056A addresses derivative contracts that call for transferring collateral to mitigate credit risk during the agreement's term. Upon such a transfer, the recipient gains title to the collateral. These circumstances give rise to uncertainty, as there is a view that the transfer of collateral might be a net settlement. This is not the intended outcome unless an extinguishment or modification in the underlying terms specified in the derivative contract has occurred. Paragraph PS 3450.056A states that if neither of these events occurs, the transfer of collateral does not result in the recognition of a gain or a loss in the statement of operations on the derivative contract. When the contract and all its terms remain in force, the transfer of collateral is treated as a deposit.
- The proposals clarify the transitional provisions.
  - Paragraph PS 3450.099(b) has been enhanced to include guidance to simplify the consolidation process for governments that control organizations that have already adopted the standard.
  - Paragraph PS 3450.101 has been added to address how unamortized discount, premiums, or transaction costs associated with a financial asset or financial liability in the amortized cost category should be accounted for upon adopting the standard.
- Paragraph A45A has been added to the Appendix in Section PS 3450 to address the accounting for certain forms of agreements involving the transfer of financial assets. This includes:
  - repurchase agreements;
  - securities lending agreements; and
  - a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the transferor.

If the transferor of a financial asset retains substantially all the risks and benefits of ownership, it is not accounted for as an asset derecognition. A repurchase agreement with this provision is accounted for as a secured borrowing. This guidance will reduce uncertainty and enhance consistency in how these transactions are accounted for.

Comments requested

PSAB welcomes comments from individuals, governments and organizations on all aspects of the Exposure Draft.

When comments have been prepared as a result of a consultative process within an organization, it is helpful to identify generically the source of the comment in the response. This promotes understanding of how the proposals affect various aspects of an organization.

Comments are most helpful if they relate to a specific principle, paragraph or group of paragraphs. Any comments that express disagreement with the proposals in the Exposure Draft should clearly explain the problem and include a suggested alternative, supported by specific reasoning.

Please respond to the following questions:

1) Do you agree with specific narrow-scope amendments proposed for Section PS 3450 as outlined in this Exposure Draft?

2) Do you agree that repurchased bonds should be offset with the corresponding financial liability for presentation purposes?

3) Do you have any other comments on the proposed narrow-scope amendments?

An online response form, linked to this document, has been provided to assist you in submitting your comments to PSAB. Alternatively, you may send comments via email (in Word format), to: info@psabcanada.ca.

FINANCIAL INSTRUMENTS, Section PS 3450

Proposal

FINANCIAL INSTRUMENTS, Section PS 3450, would be amended as indicated below. Additional text is denoted by underlining and deleted text by strikethrough.

PURPOSE AND SCOPE

…

.003 This Section does not apply to:

(a) <u>receivables and payables compulsorily paid or payable to governments and non-contractual in their origin, such as tax</u> receivables and payables relating to taxes including payments-in-lieu of taxes;

(b) …

(e) rights and obligations under leases to which LEASED TANGIBLE CAPITAL ASSETS, PSG-2, applies; however, the scope of this exception does not extend to:

(i) ~~requirements to evaluate impairment for the lessor's receivable from the lessee under a direct financing or sales type lease;~~

(ii) derecognition provisions applicable to the lessee's liability to the lessor under a capital lease; and

(iii) derivatives embedded in leases;

DERECOGNITION OF A FINANCIAL LIABILITY

…

.044 <u>If an issuer of a debt instrument repurchases that instrument (or a part of that instrument) from the market and does not legally cancel, extinguish, or discharge the liability because they are holding the instrument for sinking fund purposes, investment purposes, or have acquired the securities for and intend to resell it in the near term, then that instrument (or the repurchased part of that instrument) is not derecognized.</u> ~~If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term. A market maker facilitates market operations by standing ready to buy and sell a particular instrument. However, irrespective of the role or intent of a government, repurchases of its own securities are accounted for as an extinguishment.~~

…

.051 *If a government ~~repurchases~~ <u>extinguishes</u> a part of a financial liability, it should allocate the previous carrying amount of the financial liability between the part that continues to be <u>outstanding and the extinguished amount</u> ~~recognized and the part that is derecognized~~ based on the relative fair values of those parts on the date of the ~~repurchase~~ <u>extinguishment</u>. The difference between the carrying amount allocated to the part <u>extinguished</u> ~~derecognized~~ and the consideration paid, including any non-cash assets transferred or liabilities assumed, ~~for the part derecognized~~ should be recognized as a revenue or expense in the statement of operations.*

…

Repurchased debt instruments

.067A When a government repurchases its own debt instrument in accordance with paragraph PS3450.044, the government reporting entity would offset the repurchased instrument against the original financial liability in the statement of financial position. Similarly, any interest and expense would be offset in the statement of operations. Disclosures of the amounts that have been offset should be included in the notes to the financial statements in accordance with LONG-TERM DEBT, paragraph PS 3230.22.

PRESENTATION

Interest, dividends, gains and losses

…

.056A Consideration transferred pursuant to a credit risk management mechanism in a derivative contract does not result in the recognition of a gain or loss in the statement of operations on a derivative contract unless there is an extinguishment or modification in the underlying terms specified in the derivative contract.

TRANSITIONAL PROVISIONS

…

.099 The transition to this Section is as follows:

(a) Recognition, derecognition and measurement policies followed in financial statements for periods prior to the effective date of this Section are not reversed and, therefore, those financial statements are not restated. When transitioning to this Section, it is disclosed that the financial statements of prior periods, including comparative information, have not been restated.

(b) At the beginning of the fiscal year in which this Section is initially applied, a government or government organization:

(i) recognizes all financial assets and financial liabilities on its statement of financial position and classifies items in accordance with paragraph PS 3450.015 ~~3450.059~~;

(ii) applies the criteria in paragraphs PS 3450.020 and PS 3450.023 in identifying those financial assets and financial liabilities to be measured at fair value; and

(iii) applies the measurement provisions of this Section prospectively. The difference between a financial instrument's fair value and its previous carrying amount is ~~Any adjustment of the previous carrying amount is~~ recognized as an adjustment to the accumulated remeasurement gains and losses at the beginning of the fiscal year in which this Section is initially applied.

(iv) To the extent that the government organization had previously applied an accounting policy where financial instruments are measured at fair value with changes in fair value being recognized through operating surplus or deficit, no adjustment shall be made on transition. The financial instrument's carrying value is its fair value at the beginning of the fiscal year in which this Section is initially applied.

(v) Where the government reporting entity consolidates government organizations that are applying this Section, the controlling government adopts this Section consistent with BASIC PRINCIPLES OF CONSOLIDATION, Section PS 2500.07. This may result in an adjustment to the opening accumulated remeasurement gains and losses or an adjustment to the opening accumulated surplus or deficit.

(vi) The controlling government makes a determination of whether the adjustment described in paragraph 3450.099(b)(v) should be recorded directly to its accumulated surplus or deficit or to its accumulated remeasurement gains or losses based on the underlying government organization's application of Section PS 3450 transitional provisions.

(c) A government organization transitioning from the standards in the CPA Canada Handbook – Accounting recognizes an amount in accumulated remeasurement gains and losses at the beginning of the fiscal year in which this Section is initially applied equal to the closing accumulated other comprehensive income attributable to items classified as available for sale (or an equivalent fair value category).

…

.101 The transitional provisions in this paragraph apply to fiscal years beginning on or after April 1, 2021. Earlier adoption is permitted. At the beginning of the fiscal year in which this Section is first applied:

(a) an unamortized discount, premium, or transaction costs associated with a financial asset or financial liability measured at amortized cost is included in the item's opening carrying value; and

(b) any difference between the previous carrying value (which may have been zero) and the fair value of a derivative is recognized in the opening balance of accumulated remeasurement gains and losses.

APPENDIX A

APPLYING THE REQUIREMENTS

…

Transfers that do not qualify for derecognition

A45A The transfer of a financial asset does not result in derecognition of the transferred financial asset if the government retains substantially all the risks and benefits of ownership. Examples of when a government has retained all the risks and benefits of ownership are:

(a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;

(b) a securities lending agreement; and

(c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the government.

CONSEQUENTIAL AMENDMENT

LONG-TERM DEBT, Section PS 3230

…

DISCLOSURE

.22 *When a government holds its own securities at the end of the accounting period, including securities derecognized or offset in accordance with* FINANCIAL INSTRUMENTS, *paragraphs PS 3450.042-.051, the following should be disclosed:*

(a) the gross amount of the long-term debt classes to which the securities relate; ~~and~~

(b) the amount of the government's own securities purchased but not cancelled; and

(c) the amount of revenues and expenses that have been offset from a government's own securities purchased but not cancelled.

BASIS FOR CONCLUSIONS

Introduction

.1 This Basis for Conclusions is a supporting document to the Public Sector Accounting Board's (PSAB's) Exposure Draft, "Financial Instruments: Narrow-scope Amendments." Among other matters, it addresses:

(a) alternative views on the issues dealt with in the proposed amendments; and

(b) the Board's position, with its reasons.

.2 The Basis for Conclusions is not issued under PSAB's authority. Prior to approving the final standard, the Board will review and deliberate responses to the Exposure Draft.

Background

.3 PSAB proposes, subject to comments received following exposure, to amend FINANCIAL INSTRUMENTS, Section PS 3450, in the CPA Canada Public Sector Accounting (PSA) Handbook to change the treatment for debt buybacks and clarify aspects of the Section's application and transitional provisions.

Scope

Scope clarifications

.4 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."

.5 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.

.6 PSAB determined that it would propose amending 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.

.7 A second proposed amendment to the Section's scope of application addresses an error in drafting. PSAB proposes to remove paragraph PS 3450.003(e)(i). This clause is redundant because LEASED TANGIBLE CAPITAL ASSETS, PSG-2, focuses on how a government lessee accounts for a lease liability associated with the lease of a tangible capital asset. A government lessee would not have a receivable under PSG-2.

Derecognition of a Financial Liability

.8 Since this Section was issued, stakeholders across Canada have expressed concern about the derecognition provisions where a government issues a debt instrument then subsequently repurchases that instrument. This Section proposed to treat debt buybacks (also called "bond repurchases") as extinguishments. This would result in potentially recording a gain or loss upon repurchasing bonds from the open market, and eliminating the financial asset and debt instrument in the reporting entity.

.9 Stakeholders provided many reasons why a government repurchases its own debt from the market. Legally, the debt is not cancelled when it is reacquired. It 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; therefore, having to offer less yield to investors. 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.

.10 It is also administratively burdensome. Legally, there may be investment managers or transfer agents holding these securities. Eliminating them from the government's accounts would not change the fact that coupon payments would continue to be made, even if those payments ultimately revert to the reporting entity. PSAB considered the cost-benefit to stakeholders in revising the treatment of a bond repurchase.

.11 In developing the Exposure Draft, PSAB understood that the proposals would create accounting guidance that was inconsistent with BASIC PRINCIPLES OF CONSOLIDATION, Section PS 2500. When a reporting entity presents a liability for the debt that was originally issued and simultaneously presents an asset representing the acquisition of that debt from the open market, it would eliminate those two offsetting accounts against each other upon consolidation.

.12 In addition, presenting a repurchased bond as a financial liability while presenting the same bond as a financial asset conflicts with the definitions in PSAB's 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.

.13 As a result, PSAB proposes that bond repurchases not be treated as extinguishments but must be presented on a net basis. In other words, the repurchased bond must offset the original liability. This proposal minimizes the internal inconsistency within the PSA Handbook and addresses stakeholders' concerns.

Alternative view: Present repurchased bonds as separate financial assets

.14 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. They view the net presentation PSAB proposed as problematic. If a government is holding its own bonds at the financial statement date, large portions of a its outstanding debt may "disappear." The Board will consider stakeholder feedback on how repurchased bonds should be presented if they are not extinguished.

Presentation

.15 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.

.16 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 proposes adding paragraph PS 3450.056A.

Transitional Provisions

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

Clarifying the cost base to be used by controlling governments upon consolidation

.18 Canadian government not-for-profit organizations (GNFPOs) adopted Section PS 3450. One of the challenges they experienced was with what 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.

.19 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.

.20 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, 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.

Unamortized discounts or premiums associated with debt buybacks

.21 With the proposed modification of the treatments to debt buybacks in the Exposure Draft, a government would not have a transitional issue with unamortized discounts or premiums associated with past debt buybacks. The proposed treatment for debt buybacks 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

.22 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.

.23 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.

.24 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.

Changes in the measurement of derivatives

.25 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

.26 PSAB proposes new guidance for inclusion in Appendix A: Applying the Requirements. This 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. The Board does not expect that adding this guidance will affect how entities that already apply Section PS 3450 account for a transfer of financial assets. This Basis for Conclusions suggests that public sector entities may consult with the relevant IPSAS when considering an accounting policy on this topic.