PSAB AT A GLANCE

Section PS 3450 - Financial Instruments

January 2021

Section PS 3450 - *Financial Instruments*

Effective Date
Fiscal years beginning on or after April 1, 2022[1]

DEFINITIONS

FINANCIAL INSTRUMENT

- A contract that creates a financial asset for one entity and a financial liability or equity instrument for another entity.

FINANCIAL ASSET[2]

- An asset that can be used to discharge existing liabilities or finance future operations and is not for consumption in the normal course of operations.

FINANCIAL LIABILITY

- Any liability that is a contractual obligation:
  - To deliver cash or another financial asset to another entity; or
  - To exchange financial instruments with another entity under conditions that are potentially unfavourable to a government.

EQUITY INSTRUMENT

- Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

DERIVATIVE[3]

- A financial instrument or contract within the scope of this Section that has all three of the following characteristics:
  - It's value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the "underlying");
  - It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
  - It is settled at a future date(s).

RECOGNITION

- A financial asset or financial liability is recognized by a government on its Statement of Financial Position when it becomes a party to the contractual provisions of the instrument.
- Contracts that contain one or more embedded derivatives must be identified by a government and the guidance in paragraphs PS 3450.A18-.A26 must be followed to determine whether the government is to recognize the embedded derivative.

MEASUREMENT

MEASUREMENT CATEGORIES

- All financial instruments within the scope of PS 3450 must be measured in one of the following two categories:
  - Fair value; or
  - Cost or amortized cost.
- **Fair value**
  - The following must be included in the fair value category:
    - Derivatives; and
    - Portfolio investments in equity instruments that are quoted in an active market.
  - When a government defines and implements a risk management or investment strategy that is used to manage and evaluate the performance of a group of financial assets, financial liabilities or both on a fair value basis, the government can choose to include those items that are within the scope of PS 3450 in the fair value category. This is an accounting policy decision.
  - A contract that contains one or more embedded derivative can be designated to be carried at fair value, unless:
    - The cash flows that otherwise would be required by the contract are not significantly modified by the embedded derivative(s); or
    - The application of paragraphs PS 3450.A18-.A26 prohibits separation of the embedded derivative(s).
  - When a government measures financial instruments in the fair value category, the guidance in paragraphs PS 3450.A27-.A40 must be applied.

[1] For those government organizations that applied the CPA Canada Handbook – Accounting prior to their adoption of the CPA Canada Public Sector Accounting Handbook, this Section applies to fiscal years beginning on or after April 1, 2012. Governments and government organizations would also adopt Section PS 2601, *Foreign Currency Translation*, at the same time. Earlier adoption is permitted.
[2] Note: This definition of a financial asset in Section PS 3450, *Financial Instruments*, is not the same as the definition of a financial asset in paragraph .40 of Section PS 1000, *Financial Statement Concepts*. Refer to paragraphs PS 3450.A4-.A9 for more guidance on financial assets.
[3] When derivatives are linked to and must be settled by delivery of unquoted equity instruments they must be measured at cost.

MEASUREMENT CATEGORIES (CONTINUED)

- Remeasurement gains and losses
  - For a financial instrument in the fair value category, a change in fair value must be recognized as a remeasurement gain or loss in the Statement of Remeasurement gains and losses until the financial instrument is derecognized.
  - For a financial instrument in the fair value category that is externally restricted, a change in fair value must be recognized in accordance with the requirements in paragraphs .11-.12 of Section PS 3100, *Restricted Assets and Revenues*[4].
  - At the time when a financial instrument in the fair value category is derecognized, the associated accumulated remeasurement gains and losses are reversed and reclassified to the Statement of Operations.

EFFECTIVE INTEREST METHOD

- Must be used by a government when measuring interest for instruments measured at amortized cost.
- Refer to paragraphs PS 3450.A41-.A45 for more guidance on the effective interest method.

TRANSACTION COSTS

- When an item is in the cost or amortized cost category, transaction costs are added to the carrying value of the item upon initial recognition.
- When an item is the fair value category, transaction costs are expensed upon initial recognition.

IMPAIRMENT OF FINANCIAL ASSETS

- A government must perform an assessment of impairment on financial assets / groups of financial assets at each financial statement date. If any objective evidence of impairment exists as a result of this assessment, a government applies:
  - Section PS 3041, *Portfolio Investments*, in assessing whether any such investments are impaired and to account for any impairment; or
  - Section PS 3050, *Loans Receivable*, in assessing whether any such receivables are impaired and to account for any impairment.
- A government reports impairment losses in its Statement of Operations.

DERECOGNITION OF A FINANCIAL LIABILITY

- A financial liability / part of a financial liability is extinguished when the debtor either:
  - Discharges the liability / part of the liability by paying the creditor; or
  - Is legally released from the primary responsibility for the liability / part of the liability by the creditor or by process of law.
- When debt instruments that have substantially different terms are exchanged between the lender and the existing borrower, the original financial liability must be extinguished and a new financial liability must be recognized.
- When the terms of an existing financial liability / part of an existing financial liability are substantially modified, the original financial liability must be extinguished and a new financial liability must be recognized.
  - Refer to paragraph PS 3450.049 for guidance on determining when the terms are substantially different.
- A revenue or expense must be recognized in the Statement of Operations for the difference between the carrying amount of a financial liability / part of a financial liability extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed.
- If a government extinguishes a part of a financial liability, it should allocate the previous carrying amount of the financial liability between the part that continues to be outstanding and the extinguished amount based on the relative fair values of those parts on the date of the extinguishment. The difference between the carrying amount allocated to the part extinguished and the consideration paid, including any non-cash assets transferred or liabilities assumed, should be recognized as a revenue or expense in the statement of operations.

[4] See also our publication PSAB AT A GLANCE: Section PS 3100 – *Restricted Assets and Revenues*.

PRESENTATION

- **Interest, dividends, gains and losses**
  - Interest and dividends related to financial instruments and net settlements on derivative financial instruments attributable to the reporting period are recognized in the Statement of Operations.
  - Consideration transferred pursuant to a credit risk management mechanism in a derivative contract does not result in a gain or loss in the Statement of Operations unless there is an extinguishment or modification in the underlying terms specified in the derivative contract.
  - A gain or loss is recognized in the Statement of Operations upon derecognition of a financial instrument.
  - A gain or loss related to a financial instrument that is externally restricted is recognized as a liability until the financial instrument is used for the purpose specified, in accordance with the requirements of paragraphs .11-.12 of Section PS 3100.
- **Offsetting of a financial asset and a financial liability**
  - A financial asset and a financial liability may only be offset and the reported net in the Statement of Financial Position when, and only when:
    - The government has a legally enforceable right to set off the recognized amounts; and
    - The government intends to either settle on a net basis, or simultaneously realize the asset and settle the liability.
- **Repurchased debt instruments**
    - When a government repurchases its own debt instrument in accordance with paragraph PS 3450.044, the repurchased instrument and the original financial liability are offset in the Statement of Financial Position. Similarly, any interest revenue and interest expense associated with this repurchased debt instrument are offset in the Statement of Operations. Disclosures of the amounts that have been offset is included in the notes to the financial statements in accordance with the requirements of paragraph .22 in Section PS 3230, *Long-term Debt*.

DISCLOSURE

- A government is required to disclose information that would allow users to assess the impact of financial instruments on its financial position and changes in its financial position. The following disclosures are required.

STATEMENT OF FINANCIAL POSITION

- Carrying amount of each category of financial assets and liabilities are disclosed on the face of the Statement of Financial Position or in the notes.
- The disclosures outlined in paragraphs PS 3450.A51-.A54 are required for any items the government holds at the financial statement date that it has designated to the fair value category.
- Information on financial assets pledged as collateral.
- Details of defaults and breaches of loans payable.

STATEMENT OF REMEASUREMENT GAINS & LOSSES

- Remeasurement gains and losses are reported distinguishing between amounts occurring in the period and amounts derecognized during the period which have been reclassified to the Statement of Operations.
- Remeasurement gains and losses are presented distinguishing between those related to derivatives, portfolio investments in equity instruments quoted in an active market; and financial instruments designated to the fair value category.

OTHER DISCLOSURES

- **Accounting policies**
  - All relevant accounting policies, including the measurement basis used.
- **Derivatives**
  - Explanation of the purpose of the government's use of derivatives and how the derivatives support managing the nature and extent of risks arising from the government's financial instruments in accordance with paragraphs PS 3450.085-.096.
  - For derivatives or items designated in the fair value category, a government must disclose the methods, and when a valuation technique is used, relevant assumptions applied, in determining fair value.

FAIR VALUE HIERARCHY

- All financial instruments measured at fair value must be classified into one of the following levels, which reflect how fair value has been determined:
  - Level 1 – Quoted prices (unadjusted) in active markets for identical assets / liabilities;
  - Level 2 – Inputs other than those in Level 1, that are either directly or indirectly observable for the assets or liability; and
  - Level 3 – Inputs that are not based on observable market data (unobservable inputs).
- A financial instrument that uses inputs from more than one level is categorized based on the lowest level input that is significant to the fair value measurement in its entirety.
- The following disclosures are required for each class of financial instruments measured at fair value that are recognized in the Statement of Financial Position:
  - The level that the fair value measurements are categorized in.
  - Significant transfers of financial instruments between each category and reasons why. Transfers into and out of each level must be disclosed separately.
  - For Level 3 items:
    - A reconciliation between opening and closing balances, including gains / losses, purchases / sales / issues and settlements, and transfers in and out of Level 3 and the reasons why; and
    - If changing one or more inputs to a reasonably possible alternative would result in a significant change in fair value, this fact and the effect of the change must be disclosed.

DISCLOSURE (CONTINUED)

FAIR VALUE HIERARCHY (CONTINUED)

- When a government uses a valuation technique to determine fair value, and there is a difference between fair value at initial recognition and fair value using the valuation technique the following must be disclosed by class of financial instrument:
  - The accounting policy for reporting that difference in remeasurement gains and losses to reflect a change in factors that market participants would consider in setting a price; and
  - The aggregate difference yet to be reported in remeasurement gains and losses at the beginning and end of the period and a reconciliation of the changes in the balance of this difference.
- Unless a government discloses the quoted market value and the carrying value for portfolio investments in the cost / amortized cost categories, disclosure of fair values is not required for these instruments.

QUALITATIVE DISCLOSURE

- The following must be disclosed for each type of financial instrument risk:
  - Exposure to the risk and how it arises;
  - Objectives, policies and processes for managing the risk and methods used to measure the risk; and
  - Any changes in the above from the previous period.

QUANTITATIVE DISCLOSURE

- The following must be disclosed for each type of financial instrument risk:
  - Summary quantitative data about exposure to that risk at the financial statement date based on information provided by key management; and
  - Concentration of risks.

CREDIT RISK

- The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
- A government must disclose:
  - Maximum exposure to credit risk without taking into account collateral held or other credit enhancements and their financial effect;
  - A description of collateral held as security and other credit enhancements; and
  - Information on credit quality of financial assets that are neither past due or impaired.

LIQUIDITY RISK

- The risk that a government will encounter difficulty in meeting obligations associated with financial liabilities.
- A government must disclose:
  - A maturity analysis for non-derivative financial liabilities showing the remaining contractual maturities;
  - A maturity analysis for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of cash flows; and
  - A description of how liquidity risk in the above is managed.

MARKET RISK

- The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market price risk comprises three types of risk: currency risk, interest rate risk and other price risk.
- A government must disclose:
  - A sensitivity analysis (including methods and assumptions used) for each type of market risk the government is exposed to, showing impact on operating results (and remeasurement gains and losses when necessary); and
  - Any changes from the prior period, and reasons for the changes, in methods and assumptions used.

OR

  - If a sensitivity analysis is prepared by the government, showing interdependencies between risk variables and it is used to manage financial risks, it can be used in place of the above sensitivity analysis.
    - If this sensitivity analysis is used the following must also be disclosed:
      - Explanation of the methods used (including main parameters and assumptions underlying the data) in preparing the analysis; and
      - Explanation of the objective of the method used and limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.
  - If the sensitivity analysis is unrepresentative of an inherent risk in a financial statement this would be disclosed with the reasons why.

OTHER QUALITATIVE RISK DISCLOSURES

- **Financial assets either past due or impaired**
  - By class of financial asset the following must be disclosed:
    - Analysis of the age of financial assets past due, but not impaired at the financial statement date; and
    - Analysis of financial assets that are individually determined to be impaired at the financial statement date (including factors considered in determining they are impaired).
- **Collateral and other credit enhancements obtained**
  - The following must be disclosed for any financial or non-financial assets that were obtained during the period by taking possession of collateral the government holds as security or calling on other credit enhancements:
    - Nature and carrying amount; and
    - Policies for disposing of such assets or for using them in the government’s operations, when they are not readily convertible into cash.

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