BRIEFING NOTE

PSAB EXPOSURE DRAFT - FINANCIAL INSTRUMENTS

ISSUES

The Public Sector Accounting Board (PSAB) recently issued an exposure draft (ED) on *Financial Instruments.* The ED requires mark-to-market accounting for equities quoted in active market[1] and for derivatives. It proposes a dual bottom-line presentation of annual surplus/deficit to recognize surplus/deficit both before and after inclusion of re-measurement gains/losses (i.e. unrealized changes in fair market value).

KEY FACTS

- Certain financial instruments, defined as equities quoted in an active market and derivatives, such as interest rate and foreign exchange swaps, would be reported in the financial statements at fair value, introducing significant volatility into financial results and reducing user understanding of government financial statements for accountability and performance reporting purposes;

- Other financial instruments including equities not traded in an active market and bonds may be reported in the financial statements at cost or amortized cost, with a 'fair value option' under which a government can designate certain financial assets or liabilities to be fair valued. This option would create confusion for readers and reduce comparability of reporting among jurisdictions;

- Re-measurement of financial instruments at fair value would have a direct impact on the government's reported net debt position, resulting from the increase/decrease in fair value of financial assets and financial liabilities;

- Consistent with arguments made by governments over the past several years and consistent with government's position on the Joint Working Group, the proposed accounting treatment in this exposure draft does not reflect the economic substance of government activities. Government's activities are non-speculative in nature, derivatives are generally intended to be held to maturity and transactions such as repurchase of government securities are not necessarily intended to be an extinguishment of debt but rather part of refinancing activities by the government. PSAB's ED would reflect unrealized gains and losses associated with these activities on the face of the Statement of Operations.

- PSAB's proposed direction may also have implications for reporting of unrealized gains and losses associated with Cap and Trade auction allowances and outstanding claims liabilities reported by the PBGF.

- It continues to be Ontario's position that current note disclosure provides adequate fair market value information to meet user needs. However, there are additional areas where note disclosure might be expanded upon to address a similar scope of instruments covered by the ED. These additional areas are summarized in Appendix 'A'.

[1] An equity instrument is regarded as quoted in an active market when quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices reflect actual and regularly occurring market transactions on an arm's length basis

RECOMMENDATION

- The Province maintains its position that the introduction of fair value concepts would not enhance accountability and transparency in government financial reports, but instead introduce significant volatility into financial results of governments, and that note disclosure still serves as the most appropriate way to communicate the current value of financial instruments which government intends to hold for the long-term (i.e. maturity).

- The Province opposes the proposed dual bottom-line presentation as it will negatively impact our objective to provide clear, easily understood, and transparent financial statements to the public for accountability reporting purposes.

- Under existing accountability frameworks, PSAB's proposal would result in:
    - A change *Fiscal Transparency and Accountability Act*, 2004 (FTAA) to clarify the relevant 'bottom-line' for purposes of assessing compliance with balanced budget requirements,
    - Significant communication challenges for governments to clearly present government compliance with FTAA,
    - Additional questions from the public, media and legislatures regarding the meaning and significance of the reported 'final-line' results with regards to government's performance and its ability to provide services in the future, and
    - Potential negative impacts on government fiscal policy decisions.

- The Province supports public accounting standards which reflect the economic substance of the government's activities. For example, where a government repurchase its own debt under (debt under repurchase agreement is item (c) not item (a) which is the intention of this paragraph (where there is an opportunity to reduce financing costs), public accounting standards should allow deferral of related gains and losses rather than the proposed debt extinguishment treatment.

- PSAB's Exposure Draft does not address the government's concern about the impact of proposed changes on government's reported net debt position, upon which temporary market fluctuations resulting from the inclusion of re-measurement fair value gains and losses may reduce the meaningfulness of this measure and be incorrectly interpreted by the public, media and the legislators.

- The Province opposes the new 'fair value option' under which each government can designate certain financial assets or liabilities to be fair valued as it would impede inter-jurisdictional comparability of financial results.

- The Province does not support PSAB's proposal to mandate effective interest method to amortize bonds discounts or premiums. We feel that the current standards in PS 3050 and PS 3040 which permit the use of other methods such as straight-line should continue to exist. Switching from one method to another requires additional resources and costs which may exceed the benefits derived, where the results would not be materially different under effective interest method compared to other appropriate method (i.e. straight-line method). The choice to elect method of amortization either effective interest or straight line or combination thereof be left to the discretion of the preparers of the financial statements as permitted by PS 3050 and PS 3040.

- The Province does not support PSAB's proposal to mandate 'trade date accounting' for regular way purchase or sale of financial assets. Switching from 'settlement date accounting' to 'trade date accounting' requires additional resources and costs which may exceed the benefits derived, where the results would not be materially different under 'trade date accounting' compared to 'settlement date accounting' or combination thereof. We feel that similar to the other standards (i.e. CICA section 3855, IAS 39, FAS 133) the choice between 'trade date accounting' and 'settlement date accounting' or combination thereof be left to the discretion of the preparers of the financial statements.

- The Province does not support PSAB's proposal to eliminate synthetic instrument accounting through its removal of the principle of measuring derivatives at fair value. The current practice of netting of the assets and liabilities better reflects the economic substance of the transaction since governments hold derivatives to maturity.

BACKGROUND

In January 2006, PSAB approved a Statement of Principles (SOP) for the recognition and measurement of derivatives at fair value. In general, responses from PSAB stakeholders supported the definitions proposed for a financial instrument and a derivative and the conclusion that derivatives represent rights and obligations that meet PSAB's definitions of assets or liabilities.

In March 2007, PSAB approved a SOP on Financial Instruments. The SOP provided a set of principles addressing recognition and measurement of financial instruments (including derivatives) and hedge accounting. In general governments raised strong concerns to PSAB in their responses for the introduction of fair value concepts in their financial statements and recommended that the needs of the primary users of governments' financial statements (the public and legislators) can be better met by way of disclosing fair value information in the notes to the financial statements retaining the present accounting treatment for derivatives. It was pointed out as part other JWG that most jurisdictions already disclose substantial fair market value information in the notes to their financial statements.

In July 2007, a joint agreement was reached between representatives of PSAB and Senior Canadian governments to form a joint Deputy Ministers of Finance/PSAB working group (JWG) to consider options to deal with specific accounting concerns related to public finances (including financial instruments).

In January 2009, the JWG recommended that the needs of the primary users of governments' financial statements (the public and legislators) can be better met by way of disclosing fair value information in the notes to the financial statements of governments and retaining the present accounting treatment for derivatives and currency conversion, i.e. allow recognition at cost of all derivatives and the deferral and amortization of unrealized gains and losses on foreign currency. The JWG paper on PSAB's Conceptual Framework identified authoritative guidance in the existing framework which support Historical Cost accounting as appropriate.

In September 2009, PSAB issued its exposure draft on Financial Instruments recommending recognition and measurement of equities traded in an active market and derivatives at fair value, and cost or amortized cost for other financial instruments. To address the nature of unrealized gains and losses in the statement of operations, PSAB put forth some presentation changes to the statement of operations to show the re-measured gains and losses separately from normal revenues and expenses.

ANALYSIS

Presentation of Statement of Operations (Illustration extracted from ED)

($ millions)	20X1 Budget	20X1 Actual	20X0 Actual
Revenues (listed by type)	14,277	16,322	16,854
Expenses (listed by function or program)	14,249	14,946	14,303
Surplus/deficit excluding re-measurement gains (losses)	28	1,376	2,551
Re-measurement gains (losses)		(125)	80
Surplus/deficit		1,251	2,631

Impact to the Consolidated Statement of Operations (per OFA analysis)

Below is the presentation of double bottom line consolidated statement of operations with impact that would have on application of proposed PSAB financial instruments exposure draft to the 2008-2009 consolidated financial statements

	2008-2009		
($ millions)	Per P.A.	If ED applied	Changes
Revenues	90,472	90,472	-
Expenses	96,881	96,704	177
Surplus/deficit excluding re-measurement gains (losses)	(6,409)	(6,232)	177
Re-measurement gains (losses)	-	(1,644)	(1,644)
Surplus/deficit	(6,409)	(7,876)	(1,467)

Note: Changes in Expenses are: Elimination of net change in unamortised FX gains and deferred hedge gains of (71) million and 248 million respectively.

Below is table showing past seven years volatility in annual surplus/deficit that will result due to re-measurement gains and losses from changes in fair value of derivatives and foreign debt translation at spot rates.

Re-measurement Gains or (Losses) in millions

2002-3	2003-4	2004-5	2005-6	2006-7	2007-8	2008-9
613	(912)	(563)	(187)	2	345	(1,644)

Impact to the Consolidated Statement of Financial Position (per OFA analysis)

Below is the presentation of expanded consolidated statement of financial position with derivative assets and derivative liabilities with impact that would have on application of proposed PSAB financial instruments exposure draft to the 2008-2009 consolidated financial statements.

Consolidated Statement of Financial Position

At March 31, 2009 **(millions)**	Per P.A.	If ED applied	Change	
Liabilities				
Liabilities (other)	19,701	19,413	(288)	
Debt	176,915	178,312	1,397	Debt revaluation & FX gain amortization adjustment
Derivative Liabilities	-	7,740	7,740	
Total Liabilities	196,616	205,465		
Financial Assets				
Financial Assets (other)	43,291	43,291	-	
Derivative Assets	-	6,881	6,881	
Total Financial Assets	43,291	50,172		
Net Debt	(153,325)	(155,293)	(1,968)	
Non-Financial Assets	40,087	40,087	-	
Accumulated Deficit	(113,238)	(115,206)	(1,968)	
GDP	587,796	587,796	-	
Net Debt to GDP	26.08%	26.42%	0.33%	

Debt Extinguishment

The ED clarifies that repurchase of debt instrument is an extinguishment of debt even if the issuer is market maker (facilitate the market) or intends to resell them in near future. It further states that irrespective of the role or intent of a government, repurchase of its own securities are accounted as an extinguishment (para .44).

The difference between carrying value and consideration paid, including non cash assets transferred and assets assumed be recognized as revenue/expense (first component) and not as re-measurement gains/losses.

However, PSAB proposes that an exchange between existing borrower and lender of debt instruments without substantially different terms is not considered an extinguishment and deferral of gains/losses in such circumstances are permitted. The terms are substantially different, if the discounted present value of cash flows, including any fees paid net of any fees received using the original effective interest rate, is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability (para .47 &.48).

Ontario's current practice is to repurchases its own debt under three circumstances listed as follows:

a) Debt is purchased for cancellation and refinanced by issuing new debt to lower interest rate (may fall under para .47 & .48 and Ontario may continue its current practice to deferral of gains/losses)
b) Debt is purchased for temporary investment purposes then sold at a later date
c) Debt is purchased for debt management purposes and is funded by a repurchase agreement (note 7)

The Province does not have exposure to the debt extinguishment to the extent cancellation of old debt and refinance with new debt under (a) do not result in substantial change in terms; however repurchase of debt under (b) and (c) trigger to debt extinguishment and Province may required to recognize the gains and losses immediately to the statement of operations.

Effective Interest Rate Method

The ED prescribed effective interest method to amortize discounts and premiums on debt, it is our understanding that effective interest method is preferred method to amortize bond discounts and premiums; however, the use of effective interest method should also not be prescribed.

The existing PS 3040 (Portfolio Investments) and 3050 (loans Receivables) considered other methods, such as straight-line amortization (ON, AB, BC, CA are currently using SLM), would be appropriate and allows flexibility to choose either effective interest method or straight-line method for amortization.

PS 3040.24
"The preferred method of amortizing the investment discount is the effective interest rate method. <u>Other methods, such as straight-line amortization, may also be appropriate</u>. Regardless of the method, the amortization of the investment discount would be recorded as an increase in the carrying value of the investment and investment income".

PS 3050.25
"The preferred method of amortizing the loan discount is the effective interest rate method. This method is used to amortize bond discounts and premiums. <u>Other methods, such as straight-line amortization, may also be appropriate</u>. Regardless of the method, the amortization of the discount would be recorded as an increase in the loan balance and a credit to revenue".

Considering the existing flexibility in PSA Handbook and anticipated increased costs to compute all amortizations using the effective interest method that may exceed the benefits in cases where the results would not be materially different from switching one method to another method, standard should not prescribed the use of effective interest method, but allow flexibility to the preparers of financial statement to choose appropriate method best suitable to their organization.

Trade Date vs. Settlement Date Accounting

The ED requires to use 'trade date accounting' for purchase and sale of financial assets through recognized exchange or securities market as opposes to allow use either 'trade date accounting' or 'settlement date accounting' which is permitted under existing CICA 38558.40-44 and IAS 39.

Ontario does not see any need to reduce the current flexibility in using either of the two dates to record transactions. The time lag between the two dates is usually small and in order to record all transactions at trade date would involve accruing entries at trade date and reversals at settlement date. This process is time consuming, may require system changes and may not necessarily add to the efficiency in financial reporting. Guidance set by other standard setters provides this flexibility to preparers of financial statements. It has been the market practice to record cash instruments like bonds and money markets using settlement date and derivatives using trade date.

Embedded Derivatives

The ED proposes that if economic characteristics of embedded derivative are not closely related to the host contract, such embedded derivative should be accounted separately. If a government is required to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at a subsequent financial reporting date, it should treat the entire hybrid (combined) contract as a financial instrument carried at fair value.

From Ontario's perspective, Master Asset Vehicle (MAV) notes exchanged from ABCP are likely to have embedded derivatives under the situation that the underlying assets are leveraged Collateralized Debt Obligations. Government can either separate the embedded derivatives or report the whole hybrid contracts at fair value.

Synthetic Instruments Accounting

Synthetic instrument accounting is a practice where two or more discrete instruments, usually a cash instrument and a derivative, are accounted for as if they are a single contract. The ED proposes to eliminate synthetic instrument accounting on the premises that:

(a) it violates the principle of fair value measurement of derivatives; and

(b) it results in netting assets against liabilities, usually without the legally enforceable set-off right.

Ontario does not agree with PSAB decision to eliminate synthetic instrument accounting on the premise that it violates principle of fair value measurement as we disagree with the introduction of fair value measurement concepts and believe that synthetic instrument accounting better reflect the economic substance of the transaction since governments hold derivatives to maturity.

Financial Contract Guarantee

The ED proposes that 'financial guarantee contracts' are within the scope of financial instruments standards; however, it does not define 'financial guarantee contract'. PSAB need to clarify the term 'financial guarantee contract' and its recognition criteria. Upon discussion with PSAB, there is no need for separate standards to cover these contracts and they are still under the literature of the existing PSAB standards.

Impairment losses on non-derivative financial assets in fair value category

The ED proposes that financial assets for impairment include non-derivative financial assets in the fair value category. Impairment charges are indicative of a loss in value that reflects the expectation that the underlying economic resource has diminished in a manner that is other than temporary (OTTI). Impairment is usually arises when carrying value of the financial assets exceeds its fair value. Under proposed two bottom lines change in fair value of non-derivative financial assets is reflected as re-measurement gains/losses; however, when change in losses is other than temporary, it should be reflected as impairment under first component of statement of operations. Ontario believes that it is difficult and time consuming for government to segregate impairment loss from changes in fair value. It is also our understanding that only financial asset classified at cost is subject to impairment test, because change in financial asset classified at fair value is anyway reflected in the statement of operations.

Hedge Accounting

The ED proposes to remove hedge accounting. All changes in fair value of derivatives are recorded as re-measurement gains or losses. Hedge accounting is therefore not required, eliminating the requirement to prove hedge effectiveness.

OFA acknowledged the PSAB proposal to withdraw hedge accounting, but remain concerned with:

1. the introduction of fair value accounting where unrealized gains and losses are immediately recognized in the statement of operations, and

2. discontinuation of the current deferral and amortization treatment of realized gains and losses on hedging.

Disclosure (Analysis provided by OFA)

The value to the readers of financial statements of the Value-at-Risk (.93) of the province's entire debt portfolio is questionable. In .92, it requires a sensitivity analysis of risk variables. These calculations are better suited to financial institutions having offsetting financial assets and liabilities, in order to assess gap risk. The calculation is not simple to carry out, and is ill-suited to a borrower whose balance sheet assets are non-financial in nature.

In .A50, flexibility is provided to government to decide how much detail it provides for the financial statement disclosure, and such flexibility should also be available for government in disclosing risk.

Transition Provisions

The proposed standard would be effective for fiscal years beginning on or after April 1, 2012 and would apply prospectively, any adjustments to the opening carrying value of financial assets and financial liabilities to reflect to its fair value would be made to the accumulated surplus/deficit.

Impact of Cap & Trade Regulation

Ontario is currently pursuing Cap & Trade regulation and it appears from the Ontario's Cap and Trade regulation that allowance is tradable as a commodity and may fall within the definition of financial instruments (Congressional Budget Office in its May 15th 2009 letter to Committee on Energy and Commerce stated that "federal legislation to limit the emission of greenhouse gases (GHG) through the issuance of tradable allowances effectively would create new type of financial instrument of significant value and liquidity). PSAB-ED is silent on accounting treatment of allowances and offsets tradable in the open market. However, the International and US accounting standards boards (IASB/FASB) tentatively concluded that allowances and offsets are financial instruments and undertook a project called 'Emission Rights'. An ED will be available in Q2 of 2010 for comment. From the Province's perspective, in case of consolidated entities like OPG, there is an additional fiscal impact in the event that GBEs need to purchase and sell allowances and/or offsets in order to meet compliance obligations.

Impact on Outstanding PBGF liabilities

PSAB's proposed accounting would also impact the province's annual surplus deficit where the PBGF has outstanding (unpaid) claims on its balance sheet as would be the case if a deferred payment scheme were adopted. The outstanding liability balance would be revalued each year end and any unrealized gains/losses reflected on the Statement of Operations.

Appendix ‘A’
Financial Statement and Risk Disclosures

- Professional judgment would be apply how much detail is provided to satisfy the requirements FI standard
- If financial instruments are designated at FV, disclose exposure to credit risk, market risk etc. and method used to derive FV of financial instruments

Quantitative risk disclosures

- Disclose summary quantitative data about government’s exposure to risks based on information provided internally to key management and concentrations of risk
- Disclose quantitative maturity analysis for derivative financial liabilities with remaining contractual term (including maturity amount based on undiscounted cash flow)

Qualitative risk disclosures

Credit risk

- Disclose the amount that best represent to govt’s maximum exposure to credit risk for financial assets
- Disclose activities conducted outside GRE that give rise to credit risk and associated exposure to the credit risk.

Liquidity risk

- Disclose how govt. manages the liquidity risk inherent in the item disclosed in quantitative analysis
- Other factors to be considered are govt. commitment to borrowing facilities, diverse funding sources, internal control process and contingency plan to manage liquidity, FI that include accelerated repayment terms, margin calls for derivative instruments, govt. credit rating etc.

Market risk

- Sensitivity analysis for each type of market risk to which govt. is exposed
- Sensitivity analysis to show impact of change in risk to the income statement (i.e. impact of change in interest rate, currency rate, commodity price etc. on IS)

Interest rate risk

- Disclose risk arises on interest-bearing FIs (i.e. loans, receivables and debt instruments)

Currency risk

- Disclose risk arises on FIs denominated in a foreign currency
- Disclose sensitivity analysis for each currency to which govt. has significant exposure

Other price risk

- Disclose price risk that arises on FIs because of change in commodity prices, equity prices etc.

Appendix 'B'
OFA Analysis on PSAB ED-Financial Instruments

<u>Discussion of the concept of the Exposure Draft</u>

Variation in future obligation or cash flows - derivatives

> Extracted from Background:
> When the future obligation or cash flows associated with items are open to significant variation because of market or other risk factors, the usefulness of traditional financial reporting measures, such as cost-based information, is diminished.

The above description on derivatives is true to a private sector company which holds derivatives for an undetermined time period and as a result it does not know the future obligation or cash flows of the derivatives. However, governments hold derivatives generally to maturity and for hedging purposes only, the obligation and cash flows of a derivative over its life time are known with certainty and are not open to any significant variation.

Take an example of an interest rate swap. The cash flows of the swap over its time life are known with certainty. The fair value during its life time fluctuates but will be zero at maturity. By recognising the changes in fair value over its life time will only be misleading and do not reflect the economic substance of the use of the derivatives by government. (Note: The cash flows or future obligation in this discussion refer to the fair value of a derivative contract, but not the floating rate interest payments. A floating rate instrument has minimal fluctuations in fair value changes.)

Derivatives at fair value

Financial instruments measured at either amortized cost or fair value will create inconsistency in reporting transactions that has similar economic substances. Take the example of two governments: Government A reports a fixed rate debt, and Government B reports a floating rate debt which is swapped to a fixed rate exposure. Both debt series are recorded at amortized cost, and the derivative for Government B is measured at fair value. The effective rate, obligation and cash flows of these fixed rate obligations are the same for both governments. The only difference is that Government B is exposed to credit risk of the swap counterparty. However, Government B is required to record gains or losses in fair value changes of the swap, resulting in very different financial positions and operating results for the two governments.

Impact on Net Debt

As discussed in PSAB 1100, the Statement of Net Debt is meant to depict the government's future revenue requirements needed to finance its liabilities. By showing derivatives on the Statement of Financial position, it will impact the government's net debt levels. The impact is not reflective of the government's future revenue requirements since any gains or losses recorded are unrealized if government has the intent to hold the derivative to maturity.

Double bottom line

It could be confusing and misleading for users of government financial statements. It may bring readers to question "what is the true bottom line? It is difficult to interpret true performance of governments.

Flexibility in using trade date and settlement date to record transactions

Do not see the need to reduce the flexibility in using either of the two dates to record transactions. The time lag between the two dates is usually small and in order to record all transactions at trade date would involve accruing entries at trade date and reversals at settlement date. This process is time consuming, may require system changes and may not necessarily add to the efficiency in financial reporting. Guidance set by other standard setters provides this flexibility to preparers of financial statements. It has been the market practice to record cash instruments like bonds and money markets using settlement date and derivatives using trade date.

Extendible and Callable debt are treated differently.

Extendible and callable debt can be structured with exactly the same economic value. The cash flows and price sensitivity to interest rate changes could be the same. However, the exposure draft is suggesting two different treatments to these debt issues. ISAB is currently considering simplifying the reporting on embedded derivatives. Government's holding of embedded derivatives is very rare except interest related embedded options in debt which have economic characteristics and risks closely related to the host contracts - interest rate risk. As long as there is no leverage in the embedded derivatives, the embedded derivatives in government debt should all be considered as closely related to the host contracts. The guideline on embedded derivatives in the current exposure draft is a model adopted by the private sector which has more complicated embedded derivatives and it should be different from the public sector.

Appendix 'C'
PSAB-Financial Instruments Analysis

	PSAB-ED 2009	Comments
Concepts/ Indices	**Accumulated surplus/deficit** • Is defined as the difference between assets and liabilities or liabilities and assets respectively **Other Comprehensive Income (OCI)** • PS 1200.74B proposed that govt. that must report OCI, a separate statement of changes in accumulated surplus/deficit is desirable.	• PS 1200.74B proposed that "*Where a government must report amounts such as OCI, a separate statement that reports on changes in accumulated surplus/deficit is desirable. <u>A government reports OCI when it applies the modified equity method in reporting on the results of a GBE that is itself reporting OCI</u>.*" **Example – Federal Govt (2007-08 FS)** Accumulated deficit, beginning of year 467,268 Annual surplus . . . . 9,597 Other comprehensive income . . . . 34 479 Accumulated deficit, end of year. . . . 457,637 **Ontario's Current Practice (2009 FS)** Accumulated Deficit at beginning of year (105,617) Increase in Fair Value of ONFA at b/y - Restated Accumulated Deficit at b/y (105,617) Annual (deficit) (6,409) Decrease in fair value of ONFA (1,212) Accumulated Deficit at End of Year (113,238) • AG may direct Province to present OCI in statement of accumulated deficit/surplus.
	Surplus/deficit PS 1200 proposed two bottom lines: • Surplus/deficit excluding re-measurement gain (losses) • Surplus/deficit, which includes re-measurement gain (losses)	• PSAB proposed two bottom lines and consequential amendments to PS 1200. • Amendments impact to presentation of consolidated financial statements. • Govt. may need to change FTAA to clarify the appropriate 'bottom line' for purposes of assessing compliance with balanced budget requirements • Significant communication challenges for govt. to clearly present government compliance
	Net debt • Is defined as difference between the Province's total liabilities and financial assets. Represents the Provinces future revenue requirements to pay for past transactions and events.	• Change in FV reflects to increase/decrease in financial assets/liabilities and consequently affect net debt. • Affect to Net debt/GDP ratio

Scope	• Financial Instrument (FI) is contractual arrangement that results in financial asset or liability and recognized in the statement of financial position when, the government becomes a party to the contractual provisions of the FI.	• Scope is similar to other standards
	• For recognition of financial assets or liabilities trade date accounting would apply.	• PSAB requires trade date accounting for recognition of financial assets and liabilities.
	• Provision of loans and receivable - PS 3050 will continue to apply for concessionary loans. • Provision of loan guarantees PS 3310 and Contingent liability PS 3300 will apply for Government Loan Guarantee • ED clarify that this standards applies when Financial Guarantee Contract provides for payment s to be made in response to change in interest rate, FI price, foreign exchange rate, commodity price etc…	• PSAB FI standard does not apply to guarantees, loan commitments, concessionary loan etc. as other PSAB standards addresses these items • Financial instrument standard applies to financial guarantee contract • However, PSAB does not define 'financial guarantee contract'
Measurement Categories	**Financial Assets & Financial liabilities reported in two categories** • FV or • Cost or Amortized cost. • Quoted equities and derivatives should be classified as FV • Quoted bonds may be classified at cost and reported at amortized cost (staff analysis-para .20) • Unquoted equity may be classified at cost and reported at amortized cost • ED allows the government to elect FVO	• The default category is amortized cost • Government may elect FVO for non-derivative assets and non derivative liabilities that are managed on FV basis (i.e. govt. defines and implement risk management or investment strategy on FV basis) • Portfolio investment in equities quoted in active market and derivatives required to be classified at FV • Bonds that are part of portfolio investment quoted in active market may be classified at cost and reported at amortized cost (i.e. ABCP) No more ABCP but restructured notes called MAV notes. Potentially, it is required to be classified in assets designated in fair value due to its embedded derivatives. (SOP do not have this feature para .20) • IASB FI replacement project proposed two categories FV and amortized cost (FI with basic loan features and managed on contractual yield basis be classified at amortized cost and FI not fall under amortized cost be classified at FV)

Re-classification	**Re-classification** • Equity instruments be re-classify when it no longer qualifies to included in FV classification (FV to AC re-classification) • FV measurements resumes when quoted price for equity instruments available (AC to FV re-classification) • When equity instruments reclassified to FV, difference between cost and FV be reported as re-measurement gain or loss in the period of reclassification (para .40). • Reclassifications arising from other reasons are not permitted (para .30)	• PSAB-ED allows re-classification only for equity instruments. • When quoted price is not available and equity instruments reclassified from FV to AC, most recent market price be the new cost. • When equity instruments reclassified from AC to FV, difference between cost and FV be reported as re-measurement gain or loss in the period of reclassification. • Reclassifications arising from other reasons are not permitted • IASB FI replacement project- FI Classification and Measurement ED prohibits reclassification of FI.
Initial Measurement Financial Assets and Financial Liabilities	**Financial assets and financial liabilities** • FI classified as FV Initial measurement is FV (transaction cost recognized to statement of operations). • FI classified as amortized cost, transaction cost recognized directly to the amortized cost of such financial instrument.	• For AC category transaction costs are added to the carrying value of item in the cost. • For FV category transaction costs are expensed (If transaction costs were added to the cost, the initial carrying amount would be exceeds FV).
Initial Measurement-Financial Guarantees	**Loan Guarantees** • **Scope**: Standards apply to loan guarantee to persons and to organizations outside GRE (PS 3310.01) • **Measurement**: a loan guarantee is a contingent liability of the government and should be accounted as contingent liabilities in the financial statements (if liability is likely and a reasonable estimate is available treat as expense otherwise disclosure in notes (PS 3310.05). • Available measurement option is Present Value (PV) at govt. Weighted Average Capital Cost (WACC) (PS 3310.16).	• No Specific provision under IPSASB and GAAP for Loan guarantee. The provision of contingent liability applies for guarantees. • PSAB suggest PV measurement at WACC for loan guarantee measurement, no specific valuation method suggested under IPSASB and GAAP.

Initial Measurement- Financial Guarantees (con't)	**Financial Guarantee Contract** • Paragraph .07 states that a financial instruments standard applies to financial guarantees contract (default category is cost or AC).	• PSAB ED briefly discussed financial guarantee contract (default measurement category is cost or AC) • However, govt. may elect FVO to measure financial guarantee contracts at FV if such financial guarantee contracts are managed on FV basis. • Province issued financial guarantee in respect of OPG's nuclear station decommissioning and nuclear waste management obligations under CNSC/ONFA (note 11).
Initial Measurement Loans and Receivables	**Loans and Receivables** • ED does not discuss concessionary loans. Provisions of *Loans and Receivable-PS 3050 would continue to* apply for concessionary loans. • If concessionary terms are more in the nature of a grant, the grant portion of the transaction should be recognized as an expense when the loan is made. The grant portion would be the difference between the face value of the loan and it's PV • Initial measurement PV at govt. WACC should be use to determine the PV of loan to be expense.	• PSAB - concessionary loan is initially measured at PV using govt. WACC, while under IPSAS initial measurement is at FV. • IASB ED - concessionary loan with basic loan features and managed on contractual basis be classified at cost and measured at amortized cost (para 11).
Subsequent Measurement and treatment of unrealized gains and losses	**Financial Assets & Financial Liabilities:** • Classified at amortized cost – gain or loss recognized to statement of operation, when financial assets derecognized or impaired and amortized through amortization process. • Classified at FV (quoted equity investments)- unrealized gain or loss recognized to the second component of statement of operations. • All realized gains and losses recognized to the first component of statement of operations.	• PSAB proposed two bottom lines to recognize unrealized gains/losses separately. • First component includes realized gains/losses and impairments. • Second component includes unrealized gains/losses. • At the time of de-recognition of financial assets and financial liabilities classified at FV, balance of unrealized gains or losses be reversed from second component and recorded to the first component of statement of operations.

<table>
<tr><td>Impairment</td><td>All financial assets are subject to impairment (including non-derivative financial assets classified at fair value).
Financial assets carried at amortized cost
• Other than temporary impairment (OTTI) should be recorded to (first component) statement of operation.
Loans and Receivables
• Valuation allowances should be used to reflect loans and receivables at the lower of cost and net recoverable value (PS 3050.30).
• When the amount of a loss is known with sufficient precision, and there is no realistic prospect of recovery, the loan receivable should be reduced by the amount of that loss
• Once all or a part of a loan has been written off, the <u>W/O amount should not be reverse.</u>
Portfolio Investment
• When there has been a loss in value of a portfolio investment that is OTTI, the investment should be written down to recognize the loss. The W/O amount should be recorded in statement of operations (PS 3040.07).
• A write-down of a portfolio investment to reflect a loss in value and should <u>not be reversed</u> if there is a subsequent increase in value (PS 3040.87).</td><td>• <u>PSAB</u>- valuation allowance and Write off amount of loans and receivables should be used to reduce the amount of loan and receivable.
• <u>PSAB-</u> OTTI is not re-measurement loss and recorded to first component of IS. This presentation reflects change in the economic resources available to govt.
• <u>PSAB</u>- does not allow reversal of written-off amounts of loans and receivables and portfolio investments.
• <u>IPSAS</u>- difference between carrying value and PV of future cash flow should be used to reduce the carrying value of loans and receivables.
• <u>IPSAS-</u> allows reversal of impairment loss on financial assets carried at <u>amortized cost</u> (including loans and receivables).
• <u>GAAP-</u> allows impairment loss on loans and receivables <u>to be reverse,</u> but for other financial assets carried at AC, GAAP does not allow the impairment loss to be reversed.</td></tr>
<tr><td>Embedded derivatives</td><td>• An embedded derivative should be separated from the host contract if <u>all</u> of following conditions met:
a) Economic characteristics are not closely related to host contract;
b) A separate instrument with same terms as embedded derivative would meet the definition of derivatives; and
c) A hybrid instrument is not measured at FV.
• If a government is required to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at a subsequent financial reporting date, it should treat the entire hybrid (combined) contract as a financial instrument carried at fair value (para A23)</td><td>• <u>PSAB-</u> embedded derivative that is , not closely related to the host contract, separate instruments that meet the definition of derivative and not measured at FV, required to be accounted separately (i.e. commodity indexed interest, equity indexed interest). However, interest based on interest rate indexed is closely related to interest bearing host debt contract.
• <u>IASB</u>- to simplify accounting IASB proposed single classification approach for all financial instruments including hybrid contract with financial hosts.
• <u>IASB ED</u> clarifies that investments in contractually subordinated interest (i.e. tranches) should be measured at FV. Any tranches that provide credit protection to other tranches is a form of <u>leverage</u> and <u>not a basic loan feature.</u></td></tr>
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Synthetic Instruments Accounting	• Offsetting of a financial asset and financial liability not allow where several different financial instruments are used to emulate the features of single financial instrument (a "synthetic instrument") (para .64)	• PSAB ED does not support synthetic instruments accounting
Hedge Accounting	• PSAB removed hedge accounting requirements.	• PSAB removed hedge accounting requirements. • IASB ED for hedge accounting will be available for comment in December 2009.
De-recognition	PSAB propose that: • Re-purchase of debt instrument is an extinguishment of debt even if the issuer is market maker or intends to resell them in near future. Irrespective of the role or intent of a government, repurchase of its own securities are accounted as an extinguishment. • Substantial difference of terms or substantial modification of terms of existing liability should be accounted as an extinguishment of original liability. • The terms are substantially differ, if discounted PV of cash flow is at least 10% different from discounted PV of cash flow of original financial liability. • The difference between carrying value and consideration paid, including non cash assets transferred and assets assumed be recognized as revenue/expense (first component) and not as re-measurement gains/losses.	• Province repurchases its own debt under three circumstances listed as follows: a) Debt is purchased for cancellation and refinanced by issuing new debt to lower interest rate (PSAB allow deferring gains/losses and amortized over the remaining life of the new debt if the terms of new debt between existing borrower and lender is not substantially different from the old debt- 10% discounted PV test (para .47 &.48). b) Debt is purchased for temporary investment purposes then sold at a later date c) Debt is purchased for debt management purposes and is funded by a repurchase agreement (note 7) • PSAB ED clarifies that repurchase of debt instrument is an extinguishment of debt even if the issuer is market maker (facilitate the market) or intends to resell them in near future. Irrespective of the role or intent of a government, repurchase of its own securities are accounted as an extinguishment (para .44). • The difference between carrying value and consideration paid, including non cash assets transferred and assets assumed be recognized as revenue/expense (first component) and not as re-measurement gains/losses.
Financial Statement Disclosures	• Disclosures to support the user's needs to evaluate the significance of FIs to FS. • Details of re-measurement gains/losses • Explain purpose of holding derivatives and their use in managing risk • Disclose the valuation methods and key assumptions applied	• Hedge accounting is removed
Risk Disclosures	• Risk disclosures in notes or in financial statement and discussion and analysis	• No changes from SOP

	(crossed reference to FS) • Disclose qualitative analysis • Disclose quantitative analysis (Credit risk, liquidity risk, market risk – currency risk, interest risk and other price risk)	
Transition Provisions	• Effective April 1, 2012. Earlier adoption is encouraged. • Standard apply prospectively. Carrying values and past results would not be restated. Any adjustment to previous carrying amount is recognized as an adjustment to accumulated surplus/deficit.	• Effective April 1, 2012. • Prospective application, no re-statement required, adjustment to opening carrying values would be made to accumulated surplus/deficit. •