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PS 3400 Unpacked: Navigating the New Standards with Confidence

Effective April 1, 2023, public sector entities (“PSE”) reporting under Canadian public sector accounting standards (PSAS) will need to take into consideration PS 3400, *Revenues*.

Background – The Story So Far

Prior to PS 3400, PSAS only provided guidance on revenue recognition for a limited number of revenue transactions (e.g., government transfers (PS 3410), tax revenues (PS 3510), restructuring (PS 3430), …etc.). No standard was provided for general revenue. Rather, guidance was established as a part of financial statement concepts (PS 1000) and presentation (PS 1201). Per PS 1201:

“*Revenues, including gains, should be recognized in the period in which the transactions or events occurred that gave rise to the revenues. Gains are generally recognized when realized in the statement of operations. Items not practicably measurable until cash is received would be accounted for at that time.*”

The ambiguity of the standard along with growing complexity in revenue streams resulted in public sector entities and practitioners seeking guidance in other existing accounting frameworks. This resulted in inconsistent accounting treatment across entities.

With PS 3400, PSAS establishes a standard on how to account for and report on general revenues (e.g., excluding government transfers, tax revenue, restructuring, …etc.). This is achieved through classifying revenue transactions into two categories: exchange transactions and non-exchange transactions. The classification of revenue transactions will result in different revenue recognition criteria.

Transaction Types, We Hardly Knew Thee

How a PSE recognizes revenue will depend on the type of transaction. PSEs will need to analyze their revenue streams to understand what type of transactions in order to understand how to account for them.

Exchanges transactions are transactions where goods or services are provided to a payor for consideration. These transactions include *performance obligations* for a public sector entity arising directly from a payment or promise of consideration by a payor. (e.g., building permit with multiple inspection points and a final sign off)

Non-exchange transactions are transactions or events where there is no direct transfer of goods or services to a payor (i.e., transactions with no *performance obligations*). These may be voluntary or involuntary transactions. (e.g., traffic fine)

Hybrid transactions are transactions that have multiple components that include characteristics of exchange and non-exchange transactions. (e.g., payment composed of an admission fee and a donation).

Performance Obligations – What Are Those?

In order to understand how to classify revenue transactions, it is first important to understand what *performance obligations* are.

A <u>performance obligation</u> is an *enforceable promise* to provide *specific* goods or services to a *specific* payor. An *enforceable promise* may arise from a contract negotiated with a payor, from contract terms set by the PSE, or from the PSE's authority to provide the rights to a good or service. It is critical that PSEs understand their revenue transactions and be able to identify assess the performance obligations within each major revenue stream.

Identifying a performance obligation may not be as simple as it appears and will require careful consideration and assessment from the PSE.

A PSE's mandate or mission does not create a performance obligation nor do social policies or programs established by the PSE. This is due to the transactions being made with the general community and not with one specific payor.

Further, a performance obligation does not include activities that a PSE undertakes unless those activities provide a distinct good or service to a payor. General services or goods provided to a community do not constitute a distinct good or service. Public sector entities need to understand and identify which goods or services (or bundles of goods or services) are distinct and should be accounted for separately.

The ability to identify and assess performance obligations is further complicated when there may be multiple goods or services within a transaction, when the transaction spans multiple years, or when the transaction involves multiple contracts, contract modifications, or multiple contract counter parties.

Performance Obligations – A Liability or Not A Liability? What Is Financial?

Often, consideration will be provided by the payor prior to the performance obligations being satisfied. Although a PSE is in possession of the economic resource, if it has not fulfilled its obligation, revenue cannot be recognized, and a liability may exist. Only obligations that meet the definition of a liability (as defined in PS 3200, *Liabilities*[1]), are present obligations. Present obligations result in:

a) a duty or responsibility to others, leaving a public sector entity little or no discretion to avoid settlement of the obligation;
b) a duty or responsibility to others that entails settlement by a future transfer or use of economic resources (such as the provision of goods or services, or other forms of economic settlement) at a specified transaction or other or predetermined date, on occurrence of a specified transaction or other event, or on demand; and
c) a transaction or other event obligating the public sector entity that has already occurred.

Until the obligation is settled by the PSE, a liability will be recorded.

When assessing if a performance obligation exists, it's important to also remain cognizant of how the performance obligation will be settled. Effective April 1, 2026, the *Conceptual Framework for Financial Reporting in the Public Sector* and PS 1202, *Financial Statement Presentation*, will introduce the concept of financial and non-financial liabilities requiring separate presentation of liabilities depending on they will be settled. While the framework and standard are not effective as of 2024, the framework does require any accounting policy changes or adoption to be implemented in accordance with the new framework. Any changes in accounting standards due to PS 3400 will be subject to the requirements of PS1202 as well.

[1] Liabilities are a present economic obligation of a PSE to others as a result of past event(s), the settlement of which is expected to result in the future sacrifice of economic benefits.

Performance Obligations – We Done Yet?

A critical step in assessing performance obligations is determining if the performance obligation is settled over a *period of time* or at a *point in time*. A PSE satisfies a performance obligation over a period of time if any of the following indicators are met:

a) the payor simultaneously receives and consumes the benefits provided by the PSE's performance as the PSE fulfils the performance obligation;
b) the PSE's performance creates or enhances an asset that the payor controls or uses as the asset is created or enhanced;
c) the PSE's performance does not create an asset with an alternative use to the PSE and the PSE has an enforceable right to payment for performance completed to date;
d) the PSE is expected to continually maintain or support the transferred good or service under the terms of the arrangement; or
e) the PSE provides the payor with access to a specific good or service under the terms of the arrangement.

If a performance obligation is not satisfied over time, it is settled at a point in time. The performance obligation is satisfied when the payor obtains control of the benefits associated with the promised good or service.

Revenue Recognition – How?

Where an exchange transaction has a performance obligation settled over a period of time, revenue is recognized over a period of time to correspond to the performance obligation settlement.

Where an exchange transaction has a performance obligation settled at a point in time, revenue is recognized when the payor obtains control of the benefits associated with the promised good or service. There may be situations where terms of the agreement span multiple years. If the payor has received the promised good or service and the PSE does not have any further performance obligations, revenue is recognized entirely when the obligation is settled despite any remaining year(s). The passage of time alone does not create a performance obligation.

Where there is a non-exchange transaction (i.e., transaction with no performance obligation), a PSE recognizes revenue when the PSE:

a) has the authority to claim or retain an inflow of economic resources; and
b) identifies a past transaction or event that gives rise to an asset.

A hybrid transaction will have multiple components that may include different combinations of performance obligations, non-exchange features (e.g., fine or penalty), or another form of revenue (e.g., contribution). A PSE will need to separately account for each component of a transaction in accordance with the applicable revenue recognition criteria. In determining whether a transaction has multiple components, professional judgment is needed.

Revenue Recognition – How Much?

How much revenue to recognize will also depend on the transaction type.

For exchange transactions, a PSE should recognize revenue the portion of the transaction price[2] allocated to the performance obligation that has been satisfied. When determining the transaction price, a PSE will need to consider the effects of:

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[2] **Transaction price** is the amount of consideration a public sector entity expects to receive in exchange for promised goods or services to a payor.

a) multiple performance obligations;
b) variable consideration;
c) existence of significant concessionary terms; and
d) non-cash consideration.

For non-exchange transactions, a PSE should recognize revenue at its realizable value. This represents the future economic benefit the PSE expects to obtain.

Full Disclosure – There's More

PSEs should look at the revenue streams presented in their statement of operations. Revenue should be disaggregated and reported on the statement of operations by source and type. A separate disclosure of revenues that are not related to recurring activities should be included in the financial statements.

In addition, the accounting policies should provide a clear and concise description of typical performance obligations and the methods and policies that apply when recognizing revenue as well as the nature of continuing performance obligations grouped by category of similar transactions.

The presentation of significant revenue types, description of revenue recognition policies, and indication of revenue recurrence is meant to assist users of the financial statements interpret the resources available to the PSE, understand the annual surplus (or deficit) of the PSE, and the implication of future revenue streams.

Anything Else?

In preparation for the standard, it is important that PSEs take their time to complete proper analysis of significant revenue streams. While this may not be as arduous as implementing AROs, much of the same principles will still apply in implementing PS 3400. Things for finance and accounting departments to remain cognizant of include:

- Who should be involved?
    - Do finance personnel have a full understanding of the transaction process?
    - Do other department personnel need to be involved in the assessment process?
- What information is available?
    - Do finance personnel have access to critical information to properly recognize revenue over time?
    - Is more information required?
    - Is the information required readily available?
    - Are there any software limitations?
- How much resource will be required to appropriately implement the standard?
    - Is more staffing required?
    - Is external consultation required?

PS 3400 applies to fiscal years beginning on or after April 1, 2023. This will be applicable for public sector entities with fiscal years ending March 31, 2024, or December 31, 2024. Earlier adoption is permitted. This Section may be applied retroactively (with comparative balances being restated) or prospectively.

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