A Guide to Financial Instruments for Private Enterprises and Private Sector Not-for-Profit Organizations

Understanding the accounting for financial instruments is critical for all private enterprises following Accounting Standards for Private Enterprises (ASPE) and private sector not-for-profit organizations (NPOs) following Accounting Standards for Not-for-Profit Organizations (ASNPO), as even the simplest entities have financial instruments.

All of the accounting requirements related to financial instruments are contained in Section 3856, *Financial Instruments*, in Part II of the CPA Canada Handbook - Accounting[1]. This publication will cover all aspects of Section 3856 other than hedge accounting. For guidance on hedge accounting, see our publication A Guide to Hedge Accounting for Private Enterprises and Not-for-Profit Organizations.

Scope

A **financial instrument** is defined as a contract that creates a financial asset for one entity and a financial liability or equity instrument of another entity. To understand this definition, we must also define a financial asset, financial liability and equity instrument. They are defined as follows:

- A **financial asset** is any asset that is: cash; a contractual right to receive cash or another financial asset from another party; a contractual right to exchange financial instruments with another party under conditions that are potentially favourable; or an equity instrument of another entity;
- A **financial liability** is any liability that is a contractual obligation: to deliver cash or another financial asset to another party; or to exchange financial instruments with another party under conditions that are potentially unfavourable to the entity; and
- An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Common examples of financial instruments include:

- Cash;
- Demand and fixed-term deposits;
- Commercial paper, bankers' acceptances, treasury notes and bills;
- Accounts, notes and loans receivable and payable;
- Bonds and similar debt instruments, both issued and held as investments;
- Common and preferred shares and similar equity instruments, both issued and held as investments; and
- Options, warrants, futures contracts, forward contracts, and swaps.

In general, Section 3856 applies to all financial instruments; however, there are some financial instruments which are excluded from the scope of the standard. Most of these exclusions relate to instruments which meet the definition of a financial instrument; however, the accounting for these items is determined by another standard (e.g.. lease accounting)[2].

Contracts to buy or sell non-financial items, other than exchange traded futures contracts and contracts that are designated in a qualifying hedging relationship, are an important scope exclusion. These contracts do not meet the definition of a financial instrument because the contractual right of

[1] Private sector not-for-profit organizations following Part III of the CPA Canada Handbook follow Section 3856 from Part II of the Handbook when accounting for financial instruments.
[2] For a complete list of scope exclusions see paragraphs .03 and .04 of Section 3856.

one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation to receive, deliver or exchange a financial asset.

Another exclusion is the initial measurement of financial assets acquired or financial liabilities assumed in a transaction when a business is transferred between two enterprises under common control. This is covered in paragraph .44 of Section 3840, *Related Party Transactions*.

There are also certain paragraphs of Section 3856 that are not applicable for NPOs and instead NPOs have different reporting requirements. Refer to paragraph 3856.04A for specific details.

Recognition

Once a financial instrument has been identified and it has been determined that it is in the scope of Section 3856, a financial asset or financial liability is recognized when the entity becomes party to the contractual provisions of the instrument.

Initial Measurement

Arm's Length Financial Instruments

Upon initial recognition, all financial instruments originating in an arm's length transaction (except for retractable or mandatorily redeemable shares issued in a tax planning arrangement (RoMRS) which are discussed later in this publication) are to be measured at fair value. In most cases, this amount will be the amount of consideration paid or received, as fair value is defined as a price agreed upon by a knowledgeable willing buyer and seller, who are under no compulsion to act, in an arm's length transaction.

Directly attributable transaction costs are added to or deducted from the fair value of financial instruments that are not measured subsequently at fair value. Directly attributable transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument. These include costs such as legal fees, reimbursement of the lender's administrative costs and appraisal costs associated with a loan, but do not include financing fees, debt premiums or discounts. When a financial instrument will be subsequently measured at fair value, directly attributable transaction costs are recognized in net income in the period incurred.

In situations where there is a difference between the consideration paid or received and the fair value of the financial instrument, the difference should be recognized immediately in net income unless it qualifies as some other type of asset or liability. For example, when an entity receives an interest-free loan from a government agency, in the absence of evidence to the contrary, the difference between the fair value of the loan and the cash received is accounted for as a government grant. Similarly, when an entity extends an interest-free loan to an employee, in the absence of evidence to the contrary, the difference between the fair value of the loan and the cash paid to the employee is accounted for as employee compensation.

Related Party Financial Instruments

In the case of a financial instrument that originates as a result of a related party transaction, usually initial measurement will be at cost. The cost of the financial asset originated or acquired or the financial liability issued or assumed in the related party transaction will depend on whether or not the financial instrument has repayment terms. If the financial instrument:

a) Has repayment terms, its cost is determined using the undiscounted cash flows, excluding interest and dividend payments, less any impairment losses previously recognized by the transferor.

b) Does not have repayment terms, its cost is determined based on the consideration transferred or received by the entity. In this situation, when the consideration transferred by the entity is:

I. A financial instrument that has repayment terms, the undiscounted cash flow(s), excluding interest and dividend payments, of the financial instrument transferred as consideration less any impairment losses previously recognized by the transferor is used as cost;

II. An asset or liability that does not have repayment terms, the carrying or exchange amount (see below) of the consideration transferred or received is used as cost. In this case, the cost of the financial instrument is the exchange amount of the consideration transferred or received when:
- The transaction is in the normal course of operations; or
- The transaction is not in the normal course of operations and:
  - The transaction is a monetary transaction or a non-monetary transaction that has commercial substance;
  - The change in the ownership interests in the related financial item transferred is substantive; and
  - The amount of consideration paid or received is established and agreed to by related parties and is supported by independent evidence.

Otherwise, the cost of the financial instrument is the carrying amount of the consideration transferred or received.

As noted previously, usually related party financial instruments are initially measured at cost; however, there are exceptions in the following situations.

If the sole relationship of a party with the enterprise is in the capacity of management, the parties involved are deemed to be unrelated for the purpose of Section 3856 and as such, the transaction is initially measured at fair value. Additionally, the following related party financial instruments are initially measured at fair value without any adjustments:
- Investments in equity instruments that are quoted in an active market;
- Debt instruments that are quoted in an active market;
- Debt instruments when the inputs significant to the determination of the fair value of the instrument are observable, either directly or indirectly; and
- Derivative contracts.

Except for indexed liabilities to which paragraph 3856.14A applies (discussed below), an entity does not initially measure the variable or contingent portion of a related party financial instrument. Instead, the terms of the instrument are disclosed, and the instrument is remeasured at fair value once the contingency or variability is resolved, with any gain or loss recognized in net income.

Except for RoMRS, when a related party transaction includes a financial instrument that is in the normal course of operations or not and the transaction is a monetary or non-monetary transaction with commercial substance, the change in the ownership interests in the items transferred is substantive, and the transaction amounts for each of the elements in the transaction are supported by independent evidence, then any gain or loss resulting from initial recognition is included in net income, unless another Handbook Section requires alternative treatment. Otherwise, any gain or loss resulting from initial recognition is included in equity.

Indexed Liabilities

The issuer of a financial liability that is indexed to a measure of the entity's financial performance or to changes in the value of the entity's equity, initially measures the instrument in accordance with the requirements for arm's length transactions or related party transactions as outlined above.

Retractable or Mandatorily Redeemable Shares issued in a Tax Planning Arrangement (RoMRS)

Upon initial recognition, an entity measures RoMRS at their par, stated or assigned value if they are classified as equity, or at their redemption amount if they are classified as a financial liability. Refer to the Presentation section of the publication for the criteria to determine classification of RoMRS.

Subsequent Measurement

For most financial instruments, their subsequent measurement will depend on how they were initially measured. Subsequent measurement of financial instruments assumed in a transaction accounted for in accordance with paragraph 3840.44(b) shall be based on the initial measurement of the financial instrument in the transferred business.

Cost/Amortized Cost

If the financial instrument was initially measured at cost, it is subsequently measured using the cost method less any reduction for impairment.

Investments in equity instruments not quoted in an active market, when originated or acquired in an arm's length transaction, are measured at cost less any reduction for impairment.

All other financial assets and liabilities are measured at amortized cost, except as noted below. When determining amortized cost either the effective interest rate or straight-line methods may be used to recognize the premium or discount and all related transactions costs and financing fees over the expected life of the instrument with limited exceptions.

Fair Value

The following financial instruments are subsequently measured at fair value without any adjustment for transaction costs the entity may incur on sale/disposal:

- Investments in equity instruments that are quoted in an active market.
- Derivative contracts, except for derivatives that are designated in a qualifying hedging relationship or derivatives that are linked to, and must be settled by delivery of, equity instruments of another entity whose fair value cannot be readily determined.

Any changes in fair value are recognized in net income.

When an investment in an equity instrument of a related party ceases to be quoted in an active market, its fair value immediately before it ceases to be quoted becomes its cost, and it is then subsequently measured using the cost method.

Except for RoMRS, an entity may elect to subsequently measure any financial asset originated or acquired or financial liability issued or assumed in an arm's length transaction, at fair value by irrevocably designating the financial instrument to be measured at fair value when:

- The asset or liability is initially recognized; or
- The equity instrument ceases to be quoted in an active market.

Similarly, an entity may elect to subsequently measure any debt instruments originated or acquired or issued or assumed in a related party transaction, at fair value by irrevocably designating the instrument to be measured at fair value when the instrument is initially recognized and:

- The debt instrument is quoted in an active market; or
- The inputs significant to the determination of the fair value of the debt instrument are observable, either directly or indirectly.

When the above debt instruments cease to be quoted in an active market and/or the inputs significant to the determination of fair value are no longer observable, the instruments fair value immediately before this occurs becomes its cost, and it is subsequently measured at amortized cost.

Indexed Liabilities

The issuer of a financial liability that is indexed to a measure of the entity's financial performance or to changes in the value of the entity's equity, subsequently measures the liability at each reporting date as follows:

- For an arm's length financial liability, by adjusting the carrying amount of the liability to the higher of:
    - The amortized cost of the debt[3]; and
    - The amount that would be due at the balance sheet date if the formula determining the additional amount was applied at that date.

- For a related party financial liability, by adjusting the carrying amount of the liability to the higher of:
    - The cost of the debt; and
    - The amount that would be due at the balance sheet date if the formula determining the additional amount was applied at that date.

Adjustments are recognized in net income and presented as a separate component of interest expense.

RoMRS

An entity subsequently measures RoMRS classified as equity at their par, stated or assigned value. RoMRS classified as a financial liability are subsequently measured at their redemption amount.

Impairment

At each reporting period, impairment only needs to be considered for financial assets measured at cost, amortized cost, or using the cost method. Financial assets measured at fair value do not need to be considered because any changes in fair value are already recognized in net income.

Assessing Assets Individually or as a Group

When considering impairment, individually significant assets should be assessed individually, and other assets should be grouped on the basis of similar risk characteristics. The most common example of grouping instruments relates to accounts receivable. The following specific guidance is provided in the standard:

> *When a group of financial assets, such as accounts receivable, is comprised of large numbers of homogeneous balances of relatively small dollar amounts, impaired assets within the group are commonly identified based upon delays in receipt of payment. The extent of impairment present in the group is estimated by applying formulae that take into account the analysis of arrears, aging of balances, past loss experience, current economic conditions and other relevant circumstances such as uncompensated payment delays. To ensure that the loss ratios applied reflect the most current information available, it is necessary that the formulae be reviewed regularly.*

Impairment Indicators

The impairment model is indicator based; therefore, an entity must consider if there are any indicators of impairment. An indicator of impairment is a condition or event that will cause a significant adverse

[3] Interest expense is calculated using the stated interest rate, plus or minus the amortization of any initial premium or discount.

change in the expected timing or amount of future cash flows. Indicators of impairment include, but are not limited to the following:

- Significant financial difficulty of the customer or issuer;
- Breach of contract, (e.g. default or delinquency in interest or principal payments);
- Granting concessions to the customer or issuer;
- Becoming probable that the customer will enter bankruptcy or other financial reorganization;
- Disappearance of an active market for the asset because of financial difficulties;
- Significant adverse change in technological, market, economic or legal environment which a customer or issuer operates; and / or
- Adverse national or local economic conditions or adverse change in industry conditions.

Events or conditions which are not necessarily indicators of impairment include:

- An active market disappearing is not an indicator, unless it's because of financial difficulties;
- A downgrade of an entity's credit rating by itself is not an indicator; and
- A decline in fair value below cost or amortized cost (e.g. a decline of fair value of a debt instrument may be caused by an increase in the risk free interest rate, which has no bearing on the timing and amount of future cash flows).

Recognizing Impairment

Except as outlined below for related party debt or equity instruments, if an impairment indicator is identified, an impairment loss will be recorded to reduce the carrying amount of the financial asset, or group of similar assets, to the highest of:

a) The present value of the expected cash flows from holding the asset / group of assets discounted using the current market rate of interest;
b) The amount that could be realized by selling the asset / group of assets at the balance sheet date; and
c) The net amount the entity expects to realize by exercising its right to any collateral held to secure repayment of the asset / group of assets.

For debt instruments that were originated or acquired in a related party transaction and were initially measured at cost, an impairment loss will be recorded to reduce the carrying amount of the asset, or group of similar assets, to the highest of the undiscounted cash flows expected to be generated from holding the asset, or group of similar assets, (excluding interest and dividend payments) and the amounts specified in sub-paragraphs (b) and (c) above.

For equity instruments that originated or were acquired in a related party transaction and were initially measured at cost, an impairment loss will be recorded to reduce the carrying amount of the asset, or group of similar assets, to the amount that could be realized by selling the asset(s) at the balance sheet date.

Any impairment loss that is recorded can reduce the carrying amount of the asset, group of assets, directly or by using an allowance account through net income.

Any impairment previously recorded can be reversed through net income when events occurring after the impairment were recognized suggest a recovery in value. The previously recognized impairment loss can be reversed to the extent of the improvement. However, the adjusted carrying value of the asset, group of assets, cannot exceed the amount that would have been reported at the date of reversal had the impairment loss not been recorded.

Forgiveness

In some instances, a related party may offer forgiveness of all or a part of a related party financial asset. When this is the case, the entity must first assess and recognize any impairment in accordance with the above guidance. After that, the forgiveness of all or a part of the related party financial asset is recognized in:

- Equity when the transaction that resulted in the acquisition or origination of the financial asset was not in the normal course of operations; or
- Net income when:
  - The transaction that resulted in the acquisition or origination of the financial asset was in the normal course of operations; or
  - It is impracticable to determine whether the forgiven related party financial asset was acquired or originated in the normal course of operations or not.

A not-for-profit organization must recognize the forgiveness of a related party financial asset in the statement of operations.

Presentation

Liability vs. Equity Classification

Section 3856 requires an issuer of a financial instrument to classify the instrument, or its component parts, as a liability or equity in accordance with the substance of the contractual arrangement on initial recognition (unless the instruments are RoMRS as discussed below).

The substance of the instrument may not always match its legal form. The critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation by the issuer to deliver cash or another financial asset to the holder or to exchange another financial instrument with the holder under conditions that are potentially unfavourable to the issuer. If the obligation can be settled through the issuance of shares, it would still be considered a liability when the number of an entity's own shares or other equity instruments required to settle the obligation varies with changes in their fair value, so that the total fair value of the equity instruments to be delivered is based solely or predominantly on the amount of the contractual obligation.

<u>Exceptions</u>

The standard contains exceptions from the principle of reflecting instruments in accordance with their substance. These exceptions are:

a) Partnership interests and certain types of shares in co-operative organizations that provide for payments to the holder of a pro rata share of the residual equity of the issuer. These financial instruments may require redemption in specified circumstances that are certain to arise, such as the death of the holder, but do not impose an obligation on the issuer to deliver or exchange any specific amount of financial assets in advance of redemption. On issuance, and subject to the requirements of (b) below, such financial instruments constitute an equity instrument of the issuer and are classified as such. When the holder subsequently chooses to withdraw its equity and is entitled to do so, the issuer may become obliged to make a payment that is fixed or determinable as to amount and timing. This obligation satisfies the definition of a financial liability and is presented as such.

b) A retractable or mandatorily redeemable share, other than RoMRS (discussed below), is classified as a liability unless <u>all</u> of the following criteria are met:

   - The redeemable shares are the most subordinated of all equity instruments issued by the enterprise;

- The redemption feature is extended to 100 percent of the shares and the basis for determination of the redemption price is the same for all shares;
- The shares have no preferential rights relative to other classes of shares of the enterprise that have the same degree of subordination; and
- The redemption event is the same for all the shares subject to the redemption feature.

<u>Arm's Length Transactions</u>

In the case of an arm's length transaction, if an instrument has both liability and equity components, such as is the case with convertible debt or when warrants or options are issued with and detachable from a liability, an accounting policy choice exists as there are two acceptable methods for measurement of the liability and equity elements on initial measurement:

- The equity component is measured at zero. As a result, the entire proceeds are allocated to the liability component; or
- The less easily measurable component is allocated the residual amount after deducting from the entire proceeds of the issue the amount separately determined for the component that is more easily measurable.

<u>Related Party Transactions</u>

Similarly, in the case of related party transactions, if an instrument has both liability and equity components, an accounting policy choice exists as there are two acceptable methods for measurement of the liability and equity elements on initial measurement:

- The equity component is measured at zero. As a result, the entire proceeds are allocated to the liability component; or
- The equity component is allocated the residual amount after deducting from the entire proceeds of the issue the amount separately determined for the liability component measured in accordance with paragraph 3856.08(a) (i.e. the cost of a related party financial liability with repayment terms as discussed earlier in this publication).

<u>Retractable or Mandatorily Redeemable Preferred Shares Issued in a Tax Planning Arrangement (RoMRS)</u>

When an entity initially issues RoMRS, it may choose to present those shares at par, stated or assigned value as a separate line item in the equity section of the balance sheet, only when <u>all</u> of the following conditions are met:

- Control of the enterprise issuing the RoMRS is retained by the individual shareholder receiving the shares in the arrangement;
    - If an entity issues RoMRS to two or more related parties, an assessment of which related party, if any, controls the entity is needed to determine whether control of the entity is retained by the shareholder receiving the shares in the arrangement.
- In the arrangement either:
    - No consideration is received by the enterprise issuing the RoMRS; or
    - Only shares of the entity issuing the RoMRS are exchanged; and
- No other written or oral arrangement (such as a redemption schedule) exists, that gives the holder of the shares the contractual right to require the entity to redeem the shares on a fixed or determinable date or within a fixed or determinable period.

If any of the above conditions are not met for any or all of the shares issued, the issuer must classify those shares as a financial liability and present them separately on the face of the balance sheet at their redemption amount. Any adjustment resulting from this classification is recognized in either retained earnings or as a separate component of equity.

An entity has the option to choose to initially present RoMRS as a financial liability even if the above criteria are met. However, once RoMRS have been classified as a liability they cannot be subsequently reclassified as equity.

RoMRS that are initially classified as equity, are not subsequently reclassified to liability unless an event or transaction occurs that indicate the conditions for equity classification are no longer met. Examples of indicators that equity classification may no longer be met include, but are not restricted to:

- The death of the holder of the RoMRS;
- A change in ownership of the entity that may affect the assessment of control of the entity that issued the RoMRS;
- A change in the shareholders agreement that may affect the assessment of control of the entity that issued the RoMRS;
- Redemption of some or all of the RoMRS;
- The creation of a written or oral arrangement that gives the holder of the RoMRS the right to require the entity to redeem the shares within a fixed or determinable period; or
- Modifications to the RoMRS.

When such an event or transaction occurs, the entity must reclassify the shares from equity to liability and measure them at their redemption amount on that date and present them separately on the balance sheet. Any resulting adjustment is recorded in retained earnings or as a separate component of equity.

RoMRS classified as a financial liability are not permitted to use the callable debt presentation outlined in Section 1510, *Current Assets and Current Liabilities*.

Interest, Dividends, Losses and Gains

The classification of an instrument in the balance sheet determines whether interest, dividends, losses and gains relating to that instrument are classified as expenses or income and reported in the income statement or as a charge to equity. Dividend payments on shares classified as liabilities are classified as expenses in the same way as interest on a bond is reported in net income. Similarly, gains and losses associated with redemptions or refinancing of instruments classified as liabilities are reported in net income, while redemptions or refinancing of instruments classified as equity are reported as changes in equity. Dividends classified as an expense may be presented in the income statement either with interest on other liabilities or as a separate item. Note that forgiveness of related party assets and derecognition of related party financial liabilities are treated as outlined in the respective forgiveness and derecognition sections of this publication.

Offsetting

A financial asset and liability are offset and presented net, only when the entity meets the following conditions:

- The entity currently has a legally enforceable right to set off the recognized amounts; and
- The entity intends to either settle on a net basis, or to recognize the asset or realize the asset and settle the liability simultaneously.

Derecognition

Transfer of Receivables

In the case of transfers of receivables, an entity only derecognizes receivables transferred to another entity when control has been surrendered. The guidance to determine if control has been surrendered is complex and entities should consult with their BDO advisors on the accounting for transactions involving the sale or factoring of receivables. The criteria outlined in Appendix B of Section 3856 will determine whether the transaction should be treated as a sale or secured borrowings.

Financial Liabilities

Financial liabilities are removed from the balance sheet when extinguished. A liability is considered extinguished when the debtor discharges the liability by paying the creditor or when the debtor is legally released from primary responsibility for the liability either by process of law or by the creditor. As a result, payments to third parties, including a trust (i.e. in-substance defeasance), by itself will not result in derecognition of the liability, without legal release from the creditor.

In an arm's length transaction, when the terms of a financial liability are changed an entity needs to determine whether the change is substantial and as such should be accounted for as an extinguishment of old debt and the recognition of net debt, or whether the change is a modification of debt[4]. Extinguishment accounting will be applied when the change in terms is substantial. The change is considered substantial when:

- The present value of the cash flows under the new terms differs by at least 10% from the present value of the remaining cash flows under the original terms, both discounted at the original rate of interest; or
- There is a change in creditor and the original debt is legally discharged by the debtor through a cash payment or otherwise.

When the change terms is determined to be substantial, the difference between the carrying amount of the original financial liability extinguished and the fair value of the consideration paid is recognized in net income.

If the change in terms is not considered substantial, the entity continues to recognize the existing financial liability. In this case the fees and transaction costs accounted for as adjustments to the original debt instrument continue to be recognized in the carrying value of the financial liability and any new fees and transactions costs related to the modification are added to the carrying amount of the debt. These amounts are then amortized over the remaining term of the modified financial liability.

A transaction between related parties to replace all or part of a debt instrument with another instrument or modify the terms of the existing financial liability, must be accounted for as an extinguishment of the original financial liability and the recognition of a new financial instrument. The difference between the carrying amount of the financial liability extinguished or transferred to another related party and the amount of consideration paid is recognized either in:

- Equity, when the original transaction that resulted in the issuance or assumption of the financial liability was not in the normal course of operations; or
- Net income when:

[4] Amendments to Section 3856 for interest rate benchmark reform (IBOR reform) became effective for fiscal years ending on or after February 1, 2022 – refer to paragraphs 3856.29A-3856.29D and .69. IBOR reform refers to the market-wide reform to replace interbank offered rates (IBORs), including but not limited to the Canadian dollar offered rate (CDOR) and the London interbank offered rate (LIBOR), with alternative benchmark rates. As a practical expedient, an enterprise that modified one or more contractual terms in a debt instrument because of IBOR reform may choose to account for the modifications as if they are not substantial. The optional expedient applies to debt modifications if the terms that are modified directly replace or have the potential to replace IBORs with an alternative benchmark rate.

- The original transaction that resulted in the issuance or assumption of the financial liability was in the normal course of operations; or
- It is impracticable to determine whether the amount extinguished was issued or assumed in the normal course of operations or not.

In the case where there is an extinguishment of financial liabilities exchanged in a related party non-reciprocal transaction by an NPO, the NPO must account for the transaction in accordance with the requirements of Section 4410, *Contributions – Revenue Recognition*.

Disclosure

The overall disclosure requirement of the standard is to enable users of the financial statements to evaluate the significance of financial instruments to the entity's financial position and performance. This includes disclosure of the entity's accounting policy choices, information on the various types of financial instruments the entity holds, and the entity's exposure to risk and changes in risk exposure from the previous year for credit, currency, interest rate, liquidity and other price risk.

Conclusion

The accounting for financial instruments can be complex. Reach out to your BDO advisor for any questions you may have related to your organization's financial instruments.

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