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Flash – ASPE and ASNFPO

Related Party Financial Assets and Liabilities

February 2020 (updated: June 2020)

In December 2018, the Canadian Accounting Standards Board (AcSB) amended Section 3856, Financial Instruments, to review, in particular, requirements regarding financial assets originated or acquired and financial liabilities issued or assumed in a related party transaction (hereafter, “related party financial assets and liabilities”). The amendments apply to fiscal years beginning on or after January 1, 2021. They apply to entities that prepare their financial statements in accordance with Accounting Standards for Private Enterprises (ASPE) or Accounting Standards for Not-for-Profit Organizations (ASNFPO).

This issue of *Flash* provides a summary of the main amendments. However, it does not deal with all aspects of the accounting for related party financial assets and liabilities and the related requirements. Readers are encouraged to refer to Section 3856 before making any decisions.

June 2020 Update

Recognizing that the challenges of continuing to operate during the COVID-19 pandemic limit the time stakeholders have to consider and implement newly issued or amended standards, the AcSB decided at its April 15, 2020 meeting to defer the effective date of the amendments made to Section 3856, by one year to fiscal years beginning on or after January 1, 2021 (instead of January 1, 2020).

Background

In 2014-2015, the AcSB initiated a post-implementation review for Section 3856. In October 2017, the AcSB issued an exposure draft to address concerns raised by respondents to the review, in particular, questions about the accounting treatment of related party financial assets and liabilities:

- Do related party financial assets and liabilities fall within the scope of Section 3856 or Section 3840, Related Party Transactions, after initial recognition?
- Does the guidance of Section 3856 on the recognition and measurement of compound financial instruments issued apply to related party financial instruments initially measured in accordance with Section 3840?
- Should the impact of the impairment and forgiveness of related party financial assets be recognized in net income or equity?
- Does the guidance of Section 3856 on amendments to or the extinguishment of a financial liability apply to related party financial instruments and, if so, how?

The AcSB considered the comments received in connection with the exposure draft and, in December 2018, issued final amendments to Sections 3856 and 3840.

Under the amendments, related party financial assets and liabilities that are within the scope of Section 3856 are excluded from the scope of Section 3840 and, accordingly, the AcSB introduced new guidance in Section 3856 on the initial and subsequent measurement (including impairment), derecognition and presentation of related party financial assets and liabilities.

The amendments also apply to not-for-profit organizations (NFPOs) that apply the standards of Part III of the *CPA Canada Handbook – Accounting*. Accordingly, similar to Section 3840, the scope of Section 4460, Disclosure of Related Party Transactions by Not-for-Profit Organizations, has been amended to exclude financial assets and liabilities within the scope of Section 3856. See the NFPOs insets for clarifications applying to these entities.

In December 2018, the AcSB also issued amendments to Section 3856 with respect to retractable or mandatorily redeemable shares issued in a tax planning arrangement, which also apply to fiscal years beginning on or after January 1, 2021. The February 2019 (updated in June 2020) issue of *Flash* deals with these amendments.

Initial measurement

Related party financial assets and liabilities are initially measured at cost, with the exception of the following instruments, which 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;
- derivative contracts.

The cost of a related party asset or liability depends on whether the instrument has repayment terms.

Examples of financial instruments with repayment terms	Examples of financial instruments without repayment terms
■ Trade accounts receivable and payable; ■ Notes receivable and payable; ■ Loans receivable and payable; ■ Debt instruments with no stated repayment terms deemed to be payable on demand; ■ Investments in retractable or mandatorily redeemable shares.	■ Investments in: ◆ non-retractable common shares; ◆ warrants; ◆ preferred shares that are not retractable or mandatorily redeemable.

When the financial asset or liability has repayment terms, the cost of the instrument is determined using its undiscounted cash flow(s), excluding interest and dividend payments, less any impairment losses previously recognized by the transferor.

When the financial asset or liability does not have repayment terms, the cost of the instrument shall be determined using the consideration transferred by the entity in the transaction:

- When the consideration transferred is a financial instrument that has repayment terms, the cost of the financial asset or liability to be recognized is determined using the undiscounted cash flow(s), excluding interest or dividend payments and excluding any impairment losses of the consideration previously recognized by the transferor;

- When the consideration transferred does not have repayment terms, the cost of the financial asset or liability to be recognized is the carrying or exchange amount of the consideration transferred, depending on the circumstances.

An entity uses the exchange amount of the consideration transferred to measure a financial asset or liability that does not have repayment terms only if the transaction is in the normal course of operations or if the transaction is not in the normal course of operations and the following three conditions are satisfied:

- 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;

- 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 asset or liability that does not have repayment terms is the carrying amount of the consideration transferred.

Examples – Initial measurement

Example 1 – Related party loan

Holdco advances $100,000 to Opco, a related company, and receives a note receivable in exchange. The note receivable has a par value of $100,000, matures in five years and is non-interest bearing.

The note receivable has repayment terms, so Holdco and Opco initially measure it at $100,000, the cost determined using the undiscounted cash flows of the instrument, excluding interest and dividend payments.

Example 2 – Land transfer for non-redeemable shares

Opco transfers land to Realco, a related company, for non-redeemable share investments in the related company. The two companies are under common control of Holdco. The carrying amount of the land in Opco's accounts is $250,000 and its exchange value is $300,000.

<u>Recognition by Opco</u>

Because the non-redeemable share investment does not have repayment terms, the initial cost of the investment is measured at the value of the consideration transferred, that is the land.

Because the transaction is not in the normal course of operations, Opco must determine whether the transaction satisfies the following three conditions to measure the non-redeemable share investment:

- 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;
- The amount of consideration transferred is established and agreed to by the related parties and is supported by independent evidence.

If the three conditions are satisfied, Opco initially measures the cost of the non-redeemable share investment at the exchange value of the land transferred, that is, $300,000. However, if any of the conditions is not satisfied, the cost of the non-redeemable share investment is measured at the carrying amount of the land transferred, that is, $250,000.

<u>Recognition by Realco</u>

Realco's acquisition of the land in exchange for non-redeemable shares is recognized completely in accordance with the guidance in Section 3840. The new guidance in Section 3856 does not affect recognition of this transaction.

Gains, losses or measurement differences arising from the initial recognition

Unless another Section requires alternative treatment, any gain, loss or measurement difference resulting from initial recognition of related party assets or liabilities is included in net income in either of the following situations:

1. The transaction is in the normal course of operations;

2. The transaction is not in the normal course of operations and the following conditions are satisfied:

    - The transaction is a monetary transaction or a non-monetary transaction that has commercial substance;

    - The change in the ownership interests in the items transferred is substantive;

    - The transaction amounts for each of the elements in the transaction are supported by independent evidence.

Otherwise, any measurement difference must be included in equity.

NFPOs

Previously, accounting standards for NFPOs did not include measurement guidance for related party financial assets and liabilities. In practice, the question of whether related party financial instruments should initially be measured at fair value or at some other value often arose. The amendments clarify that the initial measurement of related party financial assets and liabilities by NFPOs must be based on the same guidance as for private enterprises.

Subsequent measurement

The new requirements on the subsequent measurement of related party financial assets and liabilities are aligned with the instrument's initial measurement. Accordingly, if a financial asset or liability was initially measured at cost, it will continue to be measured at cost, and, if it was initially measured at fair value, its subsequent measurement will be as follows:

- At fair value, if it is an investment in equity instruments that are quoted in an active market or derivative contracts, subject to some exceptions;

- At fair value, at the entity's option, in the case of debt instruments that are quoted in an active market or debt instruments where the inputs significant to the determination of the fair value of the instrument are observable;

- At amortized cost for other financial assets and liabilities.

An entity must discontinue measuring a related party financial instrument at fair value when the instrument ceases to be quoted in an active market or when the inputs significant to the determination of the fair value of the instrument are no longer observable. The fair value of the instrument immediately before the instrument ceases to be quoted in an active market or when significant inputs are no longer observable, then becomes the amount at which the instrument is recognized for subsequent measurement purposes.

NFPOs

NFPOs apply the same guidance as private enterprises for the subsequent measurement of related party financial assets and liabilities.

Retractable or mandatorily redeemable shares issued in a tax planning arrangement

It should be noted that the above-described guidance on the initial and subsequent measurement of related party financial assets and liabilities does not apply to issuers of retractable or mandatorily redeemable shares issued in a tax planning arrangement. Such shares are subject to separate requirements that are covered in the February 2019 (updated in June 2020) issue of *Flash*.

If retractable or mandatorily redeemable shares are received in a tax planning arrangement between related parties, the initial cost of the share investment is determined using the undiscounted cash flows of the shares, excluding interest or dividend payments. The subsequent measurement of the investment will continue to be at cost.

Impairment and forgiveness of related party financial assets

The new guidance states the following regarding the impairment of related party financial assets:

- The entity must measure and recognize in net income any impairment loss on a related party financial asset at the end of each reporting period;
- When a related party debt instrument is impaired, the entity must reduce the carrying amount of the asset to the highest of the following:
    - Undiscounted cash flow(s) expected to be generated by the asset, excluding interest or dividend payments;
    - The amount that could be realized by selling the asset at the balance sheet date;
    - The amount the entity expects to realize by exercising its right to any collateral held to secure repayment of the asset;
- When a related party equity instrument is impaired, the entity must reduce the carrying amount of the asset by the amount that could be realized by selling it at the balance sheet date.

The amendments also include new guidance on the forgiveness of a related party financial asset. A related party asset is forgiven when the entity terminates all or part of a liability for payment to settle the related party financial asset. Cancellation, set-off and release are examples of possible means of termination.

After assessing for and recognizing any impairment, an entity must recognize the impact of the forgiveness in:

- equity, when the transaction that resulted in the origination or acquisition of the financial asset was not in the normal course of operations;

- net income, when the transaction that resulted in the origination or acquisition 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 originated or was acquired in the normal course of operations or not in the normal course of operations;

- net income, as a compensation expense, when the financial asset is with parties whose sole relationship with the entity is in the capacity of management.

Disclosure

New disclosure requirements were added to Section 3856 with respect to forgiven related party financial assets. If an entity recognized the forgiveness of a financial asset in net income because it has determined it is impracticable to determine whether the forgiven related party financial asset was originated or was acquired in the normal course of operations or not in the normal course of operations, it must disclose that fact and the nature of the transaction that gave rise to the financial asset in its financial statements.

NFPOs

Like private enterprises, NFPOs must measure and recognize in net income any impairment loss for a related party financial asset. However, for the recognition of the impact of forgiving a financial asset, the AcSB has decided to include separate guidance for NFPOs that must always recognize the impact of forgiving a related party financial asset in the statement of operations.

Initial measurement of related party compound financial instruments

The amendment to Section 3856 introduces specific guidance on the initial measurement of the components of a related party compound financial instrument. The entity is authorized to initially measure the equity component of a related party compound financial instrument as zero; as a result, the entire proceeds of the issue are allocated to the liability component. Another acceptable method for the initial measurement of the separate liability and equity components of a related party instrument is as follows:

- The value of the liability component is measured at cost, that is, using the undiscounted cash flow(s) of the instrument, excluding interest or dividend payments;

- This value is deducted from the entire proceeds of the issue and the residual amount is allotted to the equity component.

The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the carrying amount that would be ascribed to the instrument as a whole.

NFPOs

The proposed guidance for compound financial instruments issued does not apply to NFPOs because they do not issue equity components.

Derecognition of a related party financial liability

New guidance has been introduced with respect to the derecognition of related party financial liabilities.

First, an entity must recognize any amendment to the terms of a related party financial liability or replacement of a related party financial liability by another financial instrument as the extinguishment of the original financial liability and recognition of a new financial liability. It is no longer necessary to determine if the modification of the financial liability results in a substantial modification of its terms.

Second, the impact of derecognizing a related party financial liability that has been modified or replaced by another financial liability must be recognized as follows:

- The new financial liability is recognized at cost, that is, an amount determined using the undiscounted cash flow(s) of the instrument, excluding interest or dividend payments;
- The difference between the cost of the new financial liability and the carrying amount of the original financial liability is recognized 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;
  - net income, when 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 normal course of operations.

Third, when an entity extinguishes a related party financial liability by the issue of equity instruments, it is no longer required to measure the fair value of the equity instruments issued or the fair value of the extinguished financial liability. In this situation, the equity instruments must be measured at the carrying amount of the extinguished liability.

Disclosure

New disclosure requirements were added to Section 3856 with respect to the extinguishment of related party financial liabilities. If an entity recognized the extinguishment of a financial liability in net income because it has determined it is impracticable to determine whether the extinguished related party financial liability was issued or was assumed in the normal course of operations or not in the normal course of operations, it must disclose that fact and the nature of the transaction that gave rise to the financial liability.

NFPOs

Like private enterprises, NFPOs must recognize any modification of the terms of a related party financial liability as the extinguishment of the original financial liability and the recognition of a new financial liability. However, the AcSB has decided that NFPOs must recognize the impact of the extinguishment of a related party financial liability in accordance with Section 4410, Contributions – Revenue Recognition, rather than in accordance with the guidance for private enterprises.

Other amendments

Some amendments to Section 3856 have not been specifically addressed in this publication and relate to the following topics in particular:

- The variable or contingent portion of a related party financial instrument;
- A situation where related party transactions include the exchange of multiple assets and liabilities;
- Indexed related party financial liabilities;
- The extinguishment of a convertible debt instrument issued in a related party transaction.

Effective date and transition

The amendments apply to fiscal years beginning on or after January 1, 2021. Earlier application is permitted.

The amendments are applied retrospectively, in accordance with Section 1506, Accounting Changes. The entity applies the amendment according to the following simplified transitional provisions:

- For related party financial assets and liabilities that exist at the date the amendments are applied for the first time (i.e., January 1, 2021 for entities with a December 31st year-end):
  - For a related party financial asset or liability that has repayment terms, the cost is determined as at the beginning of the earliest comparative period for the period which the amendments are applied for the first time. This cost is determined using the undiscounted cash flow(s), excluding interest or dividend payments, and less any impairment loss measured in accordance with the new guidance;
  - For a related party financial asset or liability that does not have repayment terms, the cost is deemed to be its carrying amount in the financial statements, less any impairment loss measured in accordance with the new guidance, as at the beginning of the earliest comparative period for the period which the amendments are applied for the first time;
  - For a related party financial asset or liability that is an investment in a debt or equity instrument quoted in an active market, a debt instrument where inputs significant to the determination of the fair value of the instrument are observable or a derivative contract, the cost is its fair value at the beginning of the earliest comparative period for the period which the amendments are applied for the first time;

- The entity is not required to restate a related party financial asset or liability that does not exist at the date the amendments are applied for the first time.

Our thoughts

The amendments to Section 3856 on the recognition of related party financial assets and liabilities are not expected to have a significant impact on the financial statements of most entities. That said, since the previous requirements were not precise and may have led to inconsistent practices in the recognition of related party financial assets and liabilities, it is important to confirm that the amounts recognized are in accordance with the new requirements.

Contact your Raymond Chabot Grant Thornton consultant if you have any questions about the new requirements and how to identify the potential impact of their application.

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