ASPE 3856 *Related Party Financial Instruments and Significant Risk Disclosures* Guide August 2020

Introduction

In December 2018, the Accounting Standards Board (AcSB) issued amendments to section 3856, *Financial Instruments* ("ASPE 3856") with respect to:

1. The accounting for financial assets originated or acquired, or financial liabilities issued or assumed in a related party transaction ("related party financial instruments").
2. Significant risk disclosures.

The amendments were issued in conjunction with amendments to ASPE 3856 relating to the retractable or mandatorily redeemable shares issued in a tax planning arrangement project. The amendments to ASPE 3856 as a result of this project are not the subject of this guide. Please click here to view the MNP Alert and here to view the MNP Implementation Guide that summarizes and provides guidance for the accounting for such shares.

These amendments were issued to address a number of concerns, including the fact that it was challenging to determine whether ASPE 3856 or ASPE 3840, *Related Party Transactions* ("ASPE 3840"), applied to the various elements of a related party transaction. As the objective was to clarify the accounting for related party financial instruments, the level of impact on previously recognized amounts will depend on how the previous guidance was interpreted in comparison with the new clarified guidance. Therefore, all previously recognized amounts and disclosures should be reviewed for transition to the new requirements.

The main focus of the amendments to ASPE 3856 is to:

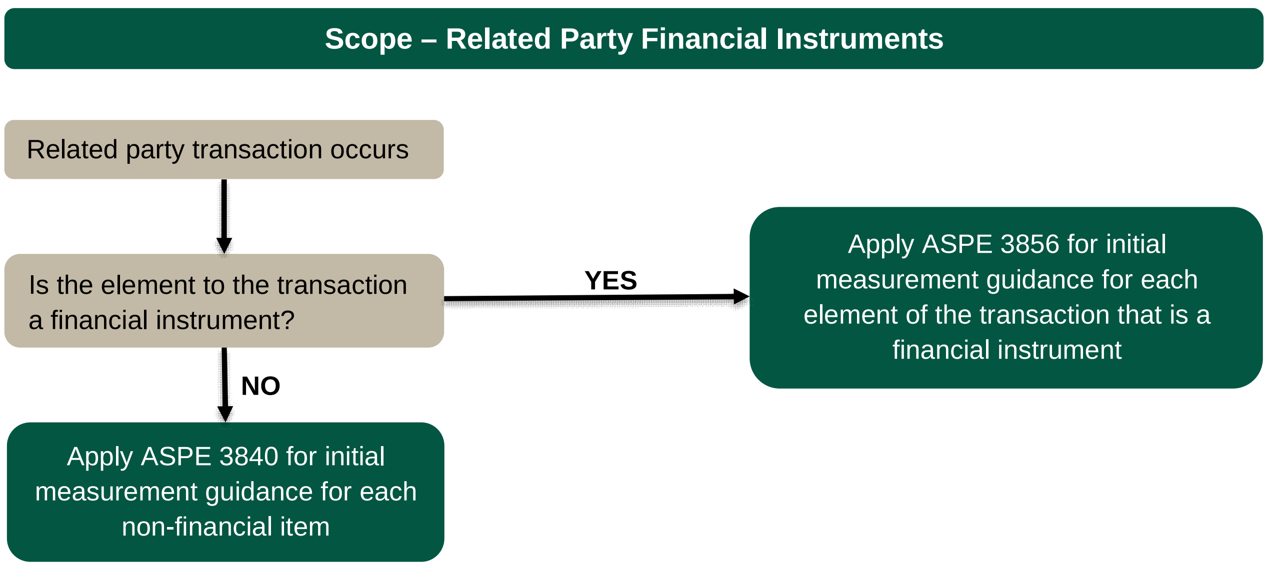
- Have a single standard that provides guidance on the accounting for financial instruments arising from transactions between both arms-length and related parties;
- Provide clearer guidance on accounting for related party financial instruments; and
- Require enterprises to disclose enterprise-specific information related to significant risks arising from financial instruments.

The amendments are effective for periods beginning on or after January 1, 2021 with earlier application permitted.

Purpose and Scope

The scope of ASPE 3856 is expanded to include the initial and subsequent measurement, derecognition, presentation and disclosure of related party financial instruments by private enterprises and not-for-profit organizations (“NFPOs”).

The measurement, recognition and derecognition of financial assets originated and financial liabilities assumed in a related party transaction are now excluded from ASPE 3840 and addressed in ASPE 3856. Moreover, when a related party transaction includes a financial instrument, any difference arising from the recognition of items exchanged in the transaction must be accounted for in accordance with the requirements of ASPE 3856. The decision tree in ASPE 3840 has been amended to illustrate which section applies to initial recognition of the financial and non-financial items in a related party transaction. Below is an excerpt:



Example 1: Land in exchange for cash and shares
Company A transfers land to Company B, a related party, in exchange for a $800,000 cash and $200,000 in common shares of Company B. The commons shares are not quoted. The transaction is not in the normal course of operations. **Assessment:** The investment in shares of a related party and cash are financial instruments, therefore, ASPE 3856 guidance applies for initial measurement, subsequent measurement and any difference resulting from the recognition of the items exchanged in the transaction. ASPE 3840 guidance applies for initial measurement of the land transferred between related parties – a non-financial item.

Initial Measurement of Related Party Financial Instruments

In general, a related party financial instrument shall be initially measured it at cost. The financial instruments not measured at cost, discussed below, shall be measured at fair value without any adjustments.

Financial Instruments at Cost
An enterprise shall initially measure a related party financial instrument at cost as follows:

- the **financial instrument has repayment terms,** its **cost is equal to** its **undiscounted cash flow(s)** (excluding interest and dividend payments, and less any impairment losses previously recognized).

- the financial instrument **does not have repayment terms, its cost is equal to the consideration** transferred or received in the transaction:
    a. The **cost is equal to its exchange amount when**:
        i. the transaction is in the normal course of operations; or
        ii. the transaction is not in the normal course of operations and:
            (a) the transaction is a monetary transaction or a non-monetary transaction that has commercial substance;
            (b) the change in the ownership interests in the related financial item transferred is **substantive**; and
            (c) the amount of consideration paid or received is established and agreed to by the related parties and supported by **independent evidence**.
    b. **Otherwise**, when the consideration **does not have repayment terms,** the **cost is equal to its carrying amount** e.g., commons shares, warrants, options and preferred shares without stated redemption amount.

Note! A non-monetary transaction has **commercial substance** when the enterprise's future cash flows are expected to change significantly as a result of the transaction because (a) the configuration (risk, timing and amount) of the future cash flows of the asset received, or (b) the enterprise-specific value of the asset received, differs significantly from that of the asset given up.

A change in ownership interest is **substantive** when there is a change in the continuity of influence over the item transferred, which occurs when:
- The nature of relationship for the transferor to the item changes (e.g., change from control, joint control, significant influence, to another category of relationship); **or**
- The residual equity ownership interest in the item transferred changes by at least 20 percent.

Independent evidence includes at lease one of:
- Independent appraisal or valuation by qualified party;
- Comparable recent quoted market prices;
- Comparable independent bids on the same transaction; or
- Comparable amounts in similar transactions undertaken with unrelated parties.

Note! Remember that when a loan's repayment terms are not specified, the loan is deemed to be payable on demand. Thus, even if a loan is described as being "without interest or terms of repayment," in applying ASPE 3856, it does in fact have repayment terms, i.e. it is payable on demand.

Example 2: Loan between related parties

Company C advances $100,000 cash to Company D, a related party, and receives a note receivable as consideration. The note is due on demand and bears interest at 5%.

Assessment: The note is not quoted in active market and significant inputs relevant to the Company D (i.e., interest rate) is not observable, therefore, it should be initially measured at cost. Because it doesn't have any repayment terms it's deemed to be payable on demand, and hence, its cost is equal to the undiscounted cash flows excluding interest and dividend payments, which is $100,000.

Example 3: Common shares issued between related parties

Company E transferred land to Company F, a related party, and received common shares in Company F as consideration. Companies E and F are wholly owned subsidiaries of Company A. The carrying amount of the land is $500,000 and exchange amount is $600,000. The transaction is not in normal course of operations and there has not been a substantive change in ownership interest.

Assessment: Given the common shares of Company F are not quoted in an active market the transaction would be initially measured at cost. The change in ownership interest is not substantive, therefore, the cost of the common shares would be measured at the carrying amount of the land of $500,000.

Exceptions to Initial Measurement at Cost

1. Financial Instruments at Fair Value

An enterprise **must initially measure at fair value**, without any adjustments, the following financial instruments originated or acquired or issued or assumed in a related party transaction:

- investments in equity instruments that are quoted in an active market;
- derivative contracts;
- debt instruments that are quoted in an active market;
- debt instruments when the inputs significant to the determination of fair value are observable, either directly or indirectly.

In practice, for private enterprises this situation will be rare.

2. Variable or Contingent Portion of a Financial Instrument

An enterprise must not initially measure the variable or contingent portion of a related party financial instrument. Instead, it shall disclose the terms of the instrument and remeasure the instrument at fair value when the contingency is resolved, with any gain or loss recognized in net income.

However, the issuer of a related party financial liability that is indexed to a measure of the enterprise's financial performance or to changes in the value of the enterprise's equity must adjust the carrying amount of the liability at each reporting date, to the higher of:

a. the cost of the debt; and
b. the amount that would be due at the balance sheet date if the formula determining the additional amount was applied at that date.

The amount of the adjustment must be recognized in net income.

3. Retractable or Mandatorily Redeemable Shares

ASPE 3856 sets out specific requirements for retractable or mandatorily redeemable shares issued in a tax planning arrangement.

- For an overview, read our Alert: Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement.
- For more detailed guidance, review MNP's implementation guide here.

Initial Measurement – Related Party Financial Instruments

Is the related party financial instrument **(i)** a derivative, **(ii)** an equity or debt investment quoted in an active market, or **(iii)** a debt instrument when the significant inputs to determine fair value are observable?

- **YES** → Initially measure at fair value without any adjustment. Any gain or loss included in net income
- **NO** ↓

Does the instrument have repayment terms?

- **YES** → Initial cost is undiscounted cash flow(s) excluding interest and dividend payments, less impairment previously recognized. Any gain or loss included in net income
- **NO** ↓

Did the consideration transferred have repayment terms?

- **YES** → Initial cost is undiscounted cash flow(s) excluding interest and dividend payments, less impairment previously recognized. Any gain or loss included in net income
- **NO** ↓

Is the transaction in the normal course of operations?

- **YES** → Initial cost is measured at the exchange amount and any gain or loss is included in net income
- **NO** ↓

Does the consideration transferred meet all the following criteria: **(a)** a monetary transaction or non-monetary transaction with commercial substance **(b)** change in ownership interest of the financial item is substantial; and **(c)** consideration paid or received is agreed by both parties and supported by independent evidence

- **YES** → Initial cost is measured at the exchange amount and any gain or loss is included in net income
- **NO** ↓

The initial cost is measured at the carrying amount of the consideration transferred for the instrument and any gain or loss is included in equity

Gains, Losses or Differences Arising in a Related Party Transaction

As mentioned above, when a related party transaction includes a financial instrument, ASPE 3856, applies to account for the difference between the exchanged items.

When the transaction is in the **normal course** of operations, **or** is n**ot in the normal course** of operations **and** the following **criteria are met**:

(i) the transaction is a monetary transaction or a non-monetary transaction that has commercial substance;
(ii) the change in the ownership interests in the items transferred is substantive; and
(iii) the transaction amounts for each of the elements in the transaction are supported by independent evidence,

any gain or loss resulting from initial recognition must be included in **net income**, unless another ASPE Section requires alternative treatment. **Otherwise**, any difference resulting from the transaction must be included in **equity**.

Note! It is important to keep this in mind that the general principle of recognizing the difference in net income when the transaction is in the normal course of operations, and in equity when it is not, is not new and is often required under ASPE 3856 and ASPE 3840..

Subsequent Measurement of Related Party Financial Instruments

In general, an enterprise must subsequently measure a related party financial instrument based on how it initially measured the instrument:

Financial instruments initially measured at cost are subsequently measured using the cost method (adjusted for any impairment losses, reversals of impairment losses or forgiveness).

Financial instruments initially measured at fair value are subsequently measured as follows:

- Investments in equity instruments that are quoted in an active market and derivative contracts: at fair value without any adjustment for transaction costs the enterprise may incur on sale or other disposal.
- Debt instruments quoted in an active market and debt instruments for which the inputs significant to the determination of their fair value are observable, either directly or indirectly: at fair value, if the enterprise irrevocably elects that fair value measurement shall apply and the instruments were so designated on initial recognition.
- Other financial assets: at amortized cost.
- Financial liabilities: at amortized cost.
- Financial liability indexed to a measure of the enterprise's financial performance or to changes in the value of the enterprise's equity: adjust the carrying amount of the liability, to the higher of (i) the cost of the debt; and (ii) the amount due at the balance sheet date if the formula determining the additional amount was applied at that date. The adjustment is recognized in net income and presented as a separate component of interest expense.

For details on the subsequent measurement of a related party financial liability indexed to a measure of the issuer's financial performance or to changes in the value of its equity and of retractable or mandatorily redeemable shares issued in a tax planning arrangement, see the Exceptions section above.

Note! When a debt or equity instrument ceases to be quoted in an active market or in case of debt instrument the inputs significant to the determination of its fair value are no longer observable, an enterprise shall measure the instrument using the cost method at each subsequent reporting date. The fair value of the instrument, immediately before the instrument ceases to be quoted in an active market or in case of a debt instrument, it ceases to have observable inputs, is the amount at which instrument is recognized.

Note! Derivative contracts that are (i) designated in a qualifying hedging relationship, (ii) linked to, and must be settled by delivery of, equity instruments of another enterprise whose fair value cannot be readily determined; are excluded from fair value measurement.

Impairment of Related Party Financial Assets

The general requirements relating to the impairment of related party financial assets (and reversals) are the same as those involving third parties. Any write-down is therefore **always** recognized in **net income.** However, the amount at which the financial asset measured at cost is reduced is slightly different in the following cases:

- Debt instruments originated or acquired in a related party transaction: reduce the carrying amount of the asset (or group of similar assets) to the highest of the following: (a) the undiscounted cash flows expected to be generated by holding the asset, excluding the interest and dividend payments of the instrument; (b) the amount that could be realized by selling the asset at the balance sheet date; and (c) the amount the enterprise expects to realize by exercising its right to any collateral held to secure repayment of the asset, net of all costs necessary to exercise those rights.
- Equity instruments originated or acquired in a related party transaction: reduce the carrying amount of the asset to the amount that could be realized by selling the asset at the balance sheet date.

These requirements apply to the party holding the financial asset. The requirements relating to derecognition of a financial liability are discussed later. Asset impairment alone does not result in derecognition of the liability for the other party.

Forgiveness of Related Party Financial Assets

A related party financial asset is forgiven when the enterprise terminates a liability for payment to settle the financial asset. Cancellation and release are examples of means of termination. After assessing for and recognizing any impairment, forgiveness of all or part of the financial asset is recognized in:

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

- **net income**, when the transaction that resulted in the origination or acquisition of the financial asset was in the **normal course** of operations **or** when it is **impracticable to determine** whether the financial asset was originated or acquired in the normal course of operations or not.

In practice, the balance of a related party financial asset is often the cumulative result of several transactions, making it impracticable to identify the original transaction. To prevent forgiveness related to transactions in the normal course of operations from ending up in equity, forgiveness must be recognized in net income when it is impracticable to determine the asset's origin.

NFPOs shall recognize the forgiveness of a related party financial asset in the statement of operations. However, they typically already do this.

These requirements apply to the party holding the financial asset; the requirements relating to derecognition of a financial liability are discussed in the following section.

Derecognition of Related Party Financial Liabilities

Extinguishment of related party financial liabilities

In a transaction between related parties, the difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another related party and the amount of the consideration paid, including any non-cash assets transferred, liabilities assumed or equity instruments issued, must be 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; or
- **net income**, (i) when the original transaction that resulted in the issuance or assumption of the financial liability was in the **normal course** of operations **or** (ii) when it is **impracticable to determine** whether the amount extinguished was issued or assumed in the normal course of operations or not.

NFPOs, however, must account for the extinguishment of financial liabilities exchanged in a related party non-reciprocal transaction (without consideration) in accordance with Section 4410, *Contributions — Revenue Recognition*, in Part III of the *CPA Canada Handbook – Accounting.*

An enterprise initially measures equity instruments issued to a creditor to extinguish all or part of a financial liability issued in a related party transaction at the carrying amount of the liability extinguished.

Replacement or modification of related party financial liabilities

A transaction between related parties to replace all or a part of a debt instrument with another instrument or to modify the terms of an existing financial liability is accounted for as an extinguishment of the original financial liability and the recognition of a new financial instrument.

Related Party Financial Instruments Containing Both a Liability and an Equity Element

See below section for details on the derecognition of a convertible debt instrument issued in a related party transaction.

Related Party Financial Instruments Containing Both a Liability and an Equity Element

This section discusses some of the unique aspects of the recognition of a financial instrument issued in a related party transaction that contains both a liability and an equity element.

Initial Measurement of Liability and Equity Elements

The issuer of a financial instrument issued in a related party transaction that contains both a liability and an equity element must classify the instrument's component parts separately. Acceptable methods for initial measurement of these components include the following:

- The equity component is measured as zero. The entire proceeds of the issue are allocated to the liability component.
- The liability component is measured using the undiscounted cash flow(s), excluding interest and dividend payments, and deducted from the entire proceeds of the issue. The difference is allocated to the equity component.

The second method differs from the one permitted when the instrument is issued in an arm's length transaction (as opposed to a related party transaction). In this case, the issuer can choose to measure the component that is easiest to measure and allocate the difference to the remaining component.

The sum of the amounts assigned to the liability and equity components on initial recognition is always equal to the amount that would be ascribed to the instrument as a whole. No gain or loss arises from recognizing the components separately.

Derecognition of Liability and Equity Elements

On extinguishment of a convertible debt instrument issued in a related party transaction, the issuer allocates the consideration paid to the liability and equity elements as follows:

a) the consideration is allocated first to the liability, up to the carrying amount of the debt, including accrued interest, and the excess, if any, is accounted for in accordance with the general extinguishment requirements mentioned previously;

b) if the consideration paid to extinguish the instrument is less than the carrying amount of the liability, any shortfall is accounted for in accordance with the general extinguishment requirements mentioned previously.

In a transaction between related parties, when an option to convert a financial liability to equity is exercised and the issuer settles the obligation in cash, the enterprise accounts for the settlement as the extinguishment of the instrument. Any difference on extinguishment of the liability element is measured and recognized in accordance with the general extinguishment requirements mentioned previously. The settlement of the equity element is recognized as a capital transaction, with any gain credited to contributed surplus and any loss applied first against contributed surplus to the extent of prior gains, and then against retained earnings.

When the issuer of an instrument that was issued in a related party transaction offers a more favourable conversion ratio than the original ratio specified in the debt agreement, or offers additional shares if the holder converts the debt security by a specified time (i.e. in an induced early conversion), the number of shares converted under the terms of the original instrument is measured at the original contract price (i.e. based on the original conversion ratio), and any additional shares issued to induce the conversion are measured at fair value. Any resulting gain or loss is treated as follows:

a) the difference relating to the liability element is recognized in accordance with the general extinguishment requirements mentioned previously;

b) the difference between the carrying amount and the amount considered to be settled relating to the holder option element is treated as a capital transaction.

Disclosures

The new disclosure requirements that apply to related party financial instruments are as follows:

- If an enterprise recognizes the **forgiveness of a related party financial asset** in net income because it is impracticable to determine whether it was originated or acquired in the normal course of operations or not, the enterprise must disclose that fact and the nature of the transaction that gave rise to the financial asset.
- An enterprise that issues a related party financial instrument with **variable or contingent payments** must disclose information that enables users of the financial statements to understand the nature, terms and effects of the variable or contingent payments, the conditions under which a payment will be made and the expected timing of any payment.
- If an enterprise recognizes the **extinguishment of a financial liability** in a related party transaction in net income because it is impracticable to determine whether it was issued or assumed in the normal course of operations or not, the enterprise must disclose that fact and the nature of the transaction that gave rise to the financial liability.

New disclosure requirements included in the amendment that apply to **all** financial instruments are as follows:

- For each significant risk (credit, currency, interest rate, liquidity, market, and other price risk) arising from financial instruments an enterprise is no longer required to illustrate the risks arising from derivatives separately. The significant risks arising from derivatives can be included along with the significant risks arising from other financial instruments.
- When preparing its financial instrument disclosures there is now an explicit requirement that an enterprise provide enterprise-specific information that enables financial statement users to evaluate the nature and extent of risks arising from financial instruments to which the enterprise is expose.

Transitional Considerations

The amendments are effective for periods beginning on or after January 1, 2021 with earlier application permitted.

An enterprise applies the amendments retrospectively with the following exceptions:

(a) for financial instruments originated or exchanged in a related party transaction that exist at the date these amendments are applied for the first time:

   (i) the **cost** of a financial instrument with **repayment terms** is determined using the **undiscounted cash flow(s), excluding interest and dividend payments**, of the instrument **less any impairment**, as at the beginning of the earliest comparative period for the period which the amendments are applied for the first time;

   (ii) the **cost** of a financial instrument that **does not have repayment terms** is deemed to be the **carrying amount** of the instrument in the financial statements of the enterprise **less any impairment**, at the beginning of the earliest comparative period for the period which the amendments are applied for the first time; or

   (iii) the **fair value** of a financial instrument that is an **investment in debt or equity instruments** that are **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** is determined at the beginning of the earliest comparative period for the period which the amendments are applied for the first time; and

(b) for financial instruments exchanged in a related party transaction that do not exist at the date these amendments are applied for the first time, an enterprise need not restate the instrument as at the beginning of the earliest comparative period.

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