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Financial Instruments in Related Party Transactions (ASPE and ASNPO)

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

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

Background

In 2014-2015, the AcSB initiated a post-implementation review for Section 3856. One area of concern raised by respondents was the accounting for financial instruments in related party transactions, including whether they fell within the scope of Section 3856 or Section 3840 *Related Party Transactions* after initial recognition.

In October 2017, the AcSB issued an exposure draft to address some of those concerns and, after considering the feedback received, issued final amendments to Sections 3856 and 3840 in December 2018.

Under the amendments, 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 initial and subsequent measurement (including impairment for financial assets), derecognition and presentation of financial instruments in related party transactions.

The amendments also apply to not-for-profit organizations (NPOs) that apply 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* was amended to exclude financial assets and liabilities within the scope of Section 3856. See the NPOs insets for clarifications applying to these entities.

Retractable or mandatorily redeemable shares issued in a tax planning arrangement

The guidance on the initial and subsequent measurement of financial instruments from related party transactions does not apply to issuers of retractable or mandatorily redeemable shares issued in a tax planning arrangement. Such shares are subject to specific requirements that are covered in a separate *Advisor Alert*. However, the guidance described in this publication still applies to holders of investments in retractable or mandatorily redeemable shares issued in a tax planning arrangement.

Initial measurement

Financial instruments in related party transactions 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; and
- derivative contracts.

The cost of a financial instrument in a related party transaction depends on whether the new instrument to be recognized 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 ◆ preferred shares that are not retractable or mandatorily redeemable ■ Warrants ■ Options

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

When a financial asset or liability in a related party transaction does not have repayment terms, the cost of the instrument cannot be determined by its own cash flows and, instead, must be determined using the characteristics of the consideration transferred or received by the entity in the transaction:

- When the consideration transferred is a financial instrument that has repayment terms, the cost of the new financial asset or liability to be recognized is determined using the undiscounted cash flow(s), excluding interest or dividend payments, of the consideration transferred, less any impairment losses previously recognized by the transferor;
- When the consideration transferred also does not have repayment terms, the cost of the new financial asset or liability to be recognized is the carrying or exchange amount of the consideration transferred or received, depending on the circumstances.

An entity uses the exchange amount of the consideration transferred or received to measure a financial asset or liability in a related party transaction 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 all 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; 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 a financial asset or liability in a related party transaction that does not have repayment terms is the carrying amount of the consideration transferred or received.

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.

In this example, the note receivable is the financial instrument in a related party transaction for which initial measurement must be determined. As the note receivable has repayment terms, both Holdco and Opco initially measure it at $100,000, which is the cost of the related party asset/liability 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 entities are under the common control of Holdco. The carrying amount of the land in Opco's accounts before the transfer is $250,000 and the agreed upon exchange amount is $300,000. Prior to the transaction, Opco did not have significant influence, joint control or control over Realco. The non-redeemable shares issued in the transaction do not provide Opco with significant influence, joint control or control over Realco.

Recognition by Opco

In this example, the non-redeemable shares are the financial instrument in a related party transaction for which initial measurement must be determined. Since 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, which in this case is the value of the land.

As the transaction is not in the normal course of operations, Opco must determine whether the transaction satisfies the following three conditions:

- 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 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 amount of the land transferred, which in this case is $300,000. However, if one or more of the conditions is not satisfied, the cost of the non-redeemable share investment is equal to the carrying amount of the land transferred, which in this case is $250,000.

Recognition by Realco

Realco's acquisition of the land in exchange for non-redeemable shares is recognized in accordance with the guidance in Section 3840. The new guidance in Section 3856 does not affect recognition of this transaction because the land is not a financial instrument and the non-redeemable shares issued by Realco would be classified as equity on its balance sheet (i.e., as share capital). Section 3856 does not provide guidance on the measurement of equity from the issuer's perspective.

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 a financial instrument in a related party transaction is included in net income if:

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

2. The transaction is not in the normal course of operations and the following conditions are all 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; and
    - 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.

Example – Measurement differences upon initial recognition

Company A sold land to Company B, a related party, in return for a $525,000 promissory note with a coupon rate of 3% and term of 2 years, issued by Company B. The promissory note is neither traded in an active market nor are the inputs to the determination of its fair value observable. At the time of the transfer, the carrying amount of the land in the accounts of Company A was $500,000 and the land's exchange amount was $550,000. The transaction was not in the normal course of operations.

Scenario 1 – Transaction does not meet all of the conditions that would result in the initial measurement difference being recognized in net income:

Company A (Seller)			**Company B (Buyer)**		
Dr. Note receivable	525,000		Dr. Land	500,000	
Cr. Land		500,000	Dr. Equity	25,000	
Cr. Equity		25,000	Cr. Note payable		525,000

The promissory note is measured at its undiscounted cash flows, excluding interest, of $525,000. Note that when the conditions to present the initial difference in net income are not met, this generally aligns with a carrying amount transaction under Section 3840 for any non-financial items being recognized (i.e., the land is recognized by Company B at its carrying amount of $500,000).

Scenario 2 Transaction meets all of the conditions that would result in the initial measurement difference being recognized in net income:

Company A (Seller)			**Company B (Buyer)**		
Dr. Note receivable	525,000		Dr. Land	550,000	
Cr. Land		500,000	Cr. Note payable		525,000
Cr. Gain (net income)		25,000	Cr. Gain (net income)		25,000

The promissory note is measured at its undiscounted cash flows, excluding interest, of $525,000. Note that when the conditions to present the initial difference in net income are met, this generally aligns with in an exchange amount transaction under Section 3840 for any non-financial items being recognized (i.e., the land is recognized by Company B at the exchange amount of $550,000).

NPOs

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

Subsequent measurement

Subject to certain exceptions, the subsequent measurement of financial instruments from related party transactions depends on how an instrument was initially measured:

Type of instrument	Initial measurement	Subsequent measurement
Investments in equity instruments that are quoted in an active market	Fair value	Fair value
Most derivative contracts		
Debt instruments that are quoted in an active market	Fair value	Amortized cost *(an entity may elect, upon initial recognition, to subsequently measure the instrument at fair value)*
Debt instruments for which the inputs significant to the determination of fair value are observable		
Other financial assets and financial liabilities	Cost	Cost method (less impairment for financial assets)

When a financial instrument from a related party transaction is subsequently measured at fair value, whether because it is required or because an entity has designated an eligible instrument as such (both cases as shown in the table above), the entity must discontinue such fair value measurement when the following occurs:

- When an investment in an equity instrument ceases to be quoted in an active market, the fair value of the instrument immediately beforehand becomes its cost. From that point forward, the instrument is subsequently measured using the cost method.
- When a debt 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 debt instrument immediately beforehand becomes its amortized cost. From that point forward, the debt instrument is measured at amortized cost.

NPOs

NPOs apply the same guidance as private enterprises for the subsequent measurement of financial instruments from related party transactions.

Retractable or mandatorily redeemable shares issued in a tax planning arrangement

As noted earlier, the guidance on the initial and subsequent measurement of financial instruments from related party transactions does not apply to issuers of retractable or mandatorily redeemable shares issued in a tax planning arrangement. However, the guidance still applies to holders of such shares.

The holder's initial cost of the share investment is the undiscounted cash flows of the shares (i.e., the redemption amount), excluding interest or dividend payments. The investment is subsequently measured using the cost method.

Impairment of financial assets from a related party transaction

The new guidance states the following regarding the impairment of financial assets originated or acquired in a related party transaction:

- An entity must assess and recognize within net income any impairment loss on a financial asset originated or acquired in a related party transaction, at the end of each reporting period;
- When a debt instrument originated or acquired in a related party transaction that is measured at cost becomes impaired, the carrying amount of the asset is reduced to the highest of the following:
    - Undiscounted cash flow(s) expected to be generated by holding the asset, excluding interest or dividend payments;
    - The amount that could be realized by selling the asset at the balance sheet date; and
    - The amount the entity expects to realize by exercising its right to any collateral held to secure repayment of the asset, net of costs.
- When a debt instrument originated or acquired in a related party transaction that is measured at amortized cost becomes impaired, the carrying amount of the asset is reduced to the highest of the following:
    - Present value of the cash flow(s) expected to be generated by holding the asset;
    - The amount that could be realized by selling the asset at the balance sheet date; and
    - The amount the entity expects to realize by exercising its right to any collateral held to secure repayment of the asset, net of costs.
- When an investment in an equity instrument originated or acquired in a related party transaction that is measured at cost becomes impaired, the carrying amount of the asset is reduced to the amount that could be realized by selling it at the balance sheet date.

Forgiveness of related party financial assets

The amendments also address the forgiveness of a related party financial asset. A related party asset, or part thereof, 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.

In related party transactions, it may be more common for an entity to forgive a financial asset that is not fully impaired. When an entity forgives all or part of a related party financial asset, it must first assess for, and recognize in net income, any impairment of that financial asset. The entity would then recognize the remaining 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 if the forgiven related party financial asset was originated or acquired in the normal course of operations;
- net income, as a compensation expense, when the financial asset is with counterparties 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 was impracticable to determine how the forgiven related party financial asset originated or was acquired (i.e., 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.

NPOs

Like private enterprises, NPOs must measure and recognize in net income any impairment loss for a related party financial asset. However, the AcSB decided to include separate guidance in ASNPO which requires that NPOs recognize the impact of forgiving a related party financial asset in the statement of operations. This treatment reflects stakeholder feedback that, prior to the amendments, many NPOs normally accounted for forgiveness in the statement of operations (e.g., as a contribution to the counterparty).

Initial measurement of related party compound financial instruments

The amendments to Section 3856 introduce specific guidance on the initial measurement of the components of a related party compound financial instrument. The entity may choose to initially measure the equity component of a related party compound financial instrument as zero (consistent with the acceptable methods used in an arm's length transaction); 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 components of a related party compound instrument is as follows:

- The value of the liability component is measured at cost (i.e., the undiscounted cash flow(s) of the instrument, excluding interest or dividend payments); and
- This value determined above 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 must always equal to the carrying amount that would be ascribed to the instrument as a whole.

NPOs

The proposed guidance for compound financial instruments issued does not apply to NPOs because these entities do not issue equity instruments.

Derecognition of a financial liability in a transaction between related parties

New guidance was introduced with respect to the derecognition of financial liabilities in a transaction between related parties.

First, a transaction between related parties to modify the terms of an existing financial liability or to replace all or part of a debt instrument with another instrument is accounted for as the extinguishment of the original financial liability and recognition of a new financial instrument. 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 financial liability in a transaction between related parties must be recognized as follows:

- Any new financial instruments are recognized in accordance with the initial measurement requirements described earlier in this publication;
- The difference between the initial measurement of the consideration paid (including the new financial instruments recognized) and the carrying amount of the original financial liability being extinguished is recognized in:
  - equity, when the original transaction that resulted in the issuance or assumption of the newly-extinguished 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 newly-extinguished financial liability was in the normal course of operations or it is impracticable to determine if the financial liability extinguished was issued or assumed in the normal course of operations.

Unlike for arm's length transactions, when an entity extinguishes a related party financial liability by issuing equity instruments, it does not need to measure the fair value of the equity instruments issued or the fair value of the extinguished financial liability. Under the amendments, 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 was impracticable to determine how the extinguished related party financial liability was issued or assumed (i.e., 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.

NPOs

Like private enterprises, NPOs 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, NPOs must recognize the impact of a non-reciprocal 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 outlined above.

Other amendments

The following topics were also affected by the amendments but are not covered as part of this publication:

- Measurement of any variable or contingent portion of a related party financial instrument;
- Situations where the related party transaction includes the exchange of multiple assets and liabilities;
- Initial and subsequent measurement of indexed related party financial liabilities; and
- Extinguishment of convertible debt instruments 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 financial instruments from a related party transaction 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) (the "application date"):
    - If the financial instrument has repayment terms, the cost is determined as at the beginning of the earliest comparative period for the period which includes the application date (e.g., January 1, 2020 for calendar year entities) (the "opening balance sheet date"), using the undiscounted cash flow(s) of the instrument, excluding interest or dividend payments, and less any impairment for financial assets, at that date;
    - If the financial instrument does not have repayment terms, the cost is deemed to be the instrument's carrying amount in the financial statements, less any impairment measured in accordance with the new guidance, as at the opening balance sheet date;
    - If the financial asset or liability is (a) an investment in a debt or equity instrument quoted in an active market, (b) a debt instrument where inputs significant to the determination of the fair value of the instrument are observable or (c) a derivative contract, the instrument is measured at its fair value at the opening balance sheet date.
- The entity need not restate a financial instrument from a related party transaction if it does not exist at the date the amendments are applied for the first time.

Our thoughts

The amendments to Section 3856 on the accounting for financial instruments in related party transactions are generally rules-based and can be complex to apply. Since the previous requirements were not precise and may have led to inconsistent practices in the recognition of financial instruments in related party transactions, it is important to confirm that the amounts recognized are in accordance with the new requirements.

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