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Accounting Standards for Private Enterprises

Accounting for Related Party Financial Instruments

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In December 2018, the Accounting Standards Board amended Section 3856, Financial Instruments (the "Section"), to address concerns on the accounting for financial instruments in a related party transaction.[1]

The amendments provide clarification on the following topics:

a. Initial and subsequent measurement of related party financial instruments;

b. Measurement of compound related party financial instruments;

c. Presentation of impairment and forgiveness of related party financial assets; and

d. Modification and extinguishment of related party financial liabilities.

The amendments will result in private enterprises applying Section 3856, Financial Instruments, for all aspects of accounting for financial instruments (i.e., including related party financial instruments). Private enterprises will continue to refer to Section 3840, Related Party Transactions, to determine whether the parties in the transaction are related, for the initial measurement of the non-financial instrument element(s) exchanged in a related party transaction and for the disclosure of related party transactions.

The amendments to the Section apply to annual financial statements relating to fiscal years beginning on or after January 1, 2020. Earlier application is permitted.

Initial and subsequent measurement of related party financial instruments

Upon adoption of the amendments, related party financial instruments will be initially measured at cost with limited exceptions.[2] Guidance on the determination of cost is provided in the Section and is influenced by whether a financial instrument in a related party transaction has repayment terms. If it has repayment terms, the cost of the instrument is determined using the undiscounted cash flow(s), excluding interest and dividend payments, of the instrument less any impairment losses previously recognized by the transferor. If it does not have repayment terms (e.g., a common share), the cost of the instrument is determined using the consideration transferred or received by the enterprise in the transaction. Further guidance is included in the Standard to help financial statement preparers determine the cost of the consideration transferred by the enterprise in the transaction.[3]

[1] The amendments also include significant risk disclosures which are outside the scope of this document.

[2] As specified in paragraphs 3856.08C-.08D and 3856.09A.

[3] Refer to paragraphs 3856.08A-.08B.

On initial measurement[4], when a related party transaction includes a financial instrument and is in the normal course of operations, or is not in the normal course of operations and meets the three criteria outlined in paragraph 3856.08E(a)-(c), any gain or loss resulting from initial recognition is included in net income, unless another section requires alternative treatment. Otherwise, any difference resulting from the transaction is included in equity.

Subsequently, the measurement of the financial instrument generally aligns with the instruments initial measurement. That is, if an instrument is initially measured at cost, it is subsequently measured using the cost method. A financial instrument that is measured at fair value is subsequently measured at cost, amortized cost or fair value depending on the specific facts and circumstances. For example, an equity instrument that is quoted in an active market exchanged in a related party transaction is required to be subsequently measured at fair value. If the equity instrument exchanged in a related party transaction were not quoted in an active market, it would be required to be subsequently measured using the cost method.

Other considerations specific to the initial and subsequent measurement of related party financial instruments, including retractable or mandatorily redeemable shares issued in a tax planning arrangement[5], the variable or contingent portion of a related party financial instrument, debt instruments and indexed financial liabilities, are also included in the amendments to the Section.

Compound related party financial instruments

Consistent with arm's length transactions, the issuer of a financial instrument that contains both a liability and an equity element, is permitted to initially measure the equity component of a compound financial instrument issued between related parties as zero. Alternatively, 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.[6] 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 and presenting the components of the instrument separately.

Presentation of impairment and forgiveness of related party financial assets

After assessing for and recognizing any impairment on related party financial assets in net income, forgiveness of all or part of a related party financial asset shall be recognized in:

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

b. net income when:

   i. the transaction that resulted in the origination or acquisition of the financial asset was in the normal course of operations; or

   ii. 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.

[4] Except for retractable or mandatorily redeemable shares issued in a tax planning arrangement to which paragraph 3856.23 applies.

[5] Refer to Crowe Soberman LLP's publication "Accounting Standards for Private Enterprises: Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement" for further details.

[6] Measured in accordance with paragraph 3856.08(a).

A borrower accounts for the extinguishment of a financial liability issued in a transaction between related parties in accordance with the guidance found in "Modification and extinguishment of related party financial liabilities", below.

Modification and extinguishment 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. 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, shall be recognized in:

a. 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

b. net income when:

   i. the original transaction that resulted in the issuance or assumption of the financial liability was in the normal course of operations; or

   ii. it is impracticable to determine whether the amount extinguished was issued or assumed in the normal or not in the normal course of operations.

A lender accounts for the forgiveness of a related party financial asset in accordance with the guidance found in "Presentation of impairment and forgiveness of related party financial assets", above.

Conclusion

The amendments provide clarification to the many challenges faced by financial statement preparers in determining the relevant section to apply to the various elements of a related party transaction. It is important for an enterprise that has previously entered into related party transactions involving financial instruments or intends to enter into related party transactions involving financial instruments to fully understand the impact of the amendments to the Section, including the application of the amendments to financial instruments originated or exchanged in a related party transaction that exist at the date the amendments are applied for the first time.

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