AcSB
Accounting Standards Board

Exposure Draft

Proposed Accounting Standards for Private Enterprises

Accounting for Related Party Financial Instruments and Significant Risk Disclosures

(Proposed amendments to Financial Instruments, Section 3856)

October 2017

COMMENTS TO THE AcSB MUST BE RECEIVED BY January 29, 2018

Respondents are asked to email their comment letters (in a Word file) to:
info@acsbcanada.ca

Please address your comments to:

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This Exposure Draft reflects proposals made by the Accounting Standards Board (AcSB).

Individuals and organizations are invited to send written comments on the Exposure Draft proposals. Comments are requested from those who agree with the Exposure Draft as well as from those who do not.

Comments are most helpful if they relate to a specific paragraph or group of paragraphs. Any comments that express disagreement with the proposals in the Exposure Draft should clearly explain the problem and include a suggested alternative, supported by specific reasoning. All comments received by the AcSB will be available on the website shortly after the comment deadline, unless confidentiality is requested. The request for confidentiality must be stated explicitly within the response.

Highlights

The Accounting Standards Board (AcSB) proposes, subject to comments received following exposure, to amend FINANCIAL INSTRUMENTS, Section 3856 in Part II of the CPA Canada Handbook – Accounting as set out in this Exposure Draft. These amendments would also apply to not-for-profit organizations (NFPOs) using the standards in Part III.

The Board understands that some stakeholders raised various issues regarding Section 3840. The objective of these proposals is to address concerns on the accounting for related party financial instruments. The Board is considering whether to undertake a project relating to Section 3840 in the context of its consultation with stakeholders about the relative priorities for Part II projects.

Background

In October 2014, the Board issued a post-implementation review for Section 3856. A summary of the feedback received during the post-implementation review is available in the Feedback Statement the Board published in September 2015.

These proposals include limited scope amendments to clarify the purpose of financial instrument risk disclosures as well as to address the following issues respondents raised relating to the accounting for related party financial instruments:

- It is unclear whether related party financial instruments are in the scope of Section 3856 or RELATED PARTY TRANSACTIONS, Section 3840, after initial recognition.
- It is unclear whether the guidance in Section 3856 relating to the recognition and measurement of compound financial instruments is available for related party financial instruments initially measured in accordance with Section 3840.
- It is unclear whether the impairment and forgiveness of related party financial instruments should be recognized in net income or in equity.
- It is challenging to apply the guidance in Section 3856 to the modification and extinguishment of related party financial liabilities.

Main features of the Exposure Draft

The amendments proposed in this Exposure Draft are as follows:

Scope of Section 3856

- The scope of Section 3856 would be amended to make clear that the Section would apply to the initial and subsequent measurement, derecognition, presentation and disclosure of related party financial instruments.
- Guidance on how NFPOs initially measure related party financial instruments would be added to Section 3856.

Initial measurement of related party financial instruments

- Guidance on how to initially measure related party financial instruments would be included in Section 3856 as follows:
    - Measure financial instruments at cost, unless the instrument is equity that is quoted in an active market or a derivative contract.

- Measure financial instruments that are quoted in an active market and derivative contracts at fair value without any adjustment.
- Prohibit the election to measure financial assets or financial liabilities at fair value.

- The cost of a financial instrument in a related party transaction would depend on whether the instrument has repayment terms. When the financial instrument has repayment terms, the cost of the instrument would be determined using the undiscounted cash flow(s) of the instrument, excluding interest and dividend payments. When the financial instrument does not have repayment terms, the cost of the instrument would be determined using the consideration transferred by the enterprise in the transaction, as follows:
  - When the consideration transferred is a financial instrument that has repayment terms, the cost of the instrument is determined using the undiscounted cash flows, excluding interest and dividend payments, of the financial instrument transferred as consideration.
  - When the consideration transferred does not have repayment terms, the cost of the instrument is determined at either the carrying or exchange amount of the consideration transferred, depending on the circumstances.

Subsequent measurement

- Guidance on how to subsequently measure related party financial instruments would be included in Section 3856 as follows:
  - Measure investments in equity instruments that are quoted in an active market and derivative contracts at fair value.
  - Measure all other instruments at cost, less any reduction for impairment.

Measurement of compound related party financial instruments

- An enterprise would be permitted to initially measure the equity component of a related party compound financial instrument as zero.

Presentation of impairment and forgiveness of related party financial assets

- An enterprise would be required to first assess for, and recognize in net income, any impairment of a related party financial asset before the forgiveness of the related party financial asset is recognized.
- When a related party financial asset is impaired, an enterprise would reduce the carrying amount of the instrument to the highest of the following:
  - the undiscounted cash flows expected to be generated by holding the asset, excluding the interest and dividend payments of the instrument;
  - the amount that could be realized by selling the asset; and
  - the amount the enterprise expects to realize by exercising its right to any collateral.
- Except for NFPOs, the forgiveness of a related party financial asset would be recognized in:
  - equity when the original transaction that resulted in acquiring the financial asset was not in the normal course of operations; or
  - net income when the original transaction that resulted in acquiring the financial asset was in the normal course of operations or when it is impracticable to determine whether the amount forgiven originated outside the normal course of operations.

- NFPOs do not have equity. Therefore, the Board decided to exclude them from the scope of its proposal in paragraph 3856.19A. Furthermore, Part III of the Handbook does not have guidance on how to account for the forgiveness of financial assets between related parties. As such, the Board may consider issuing guidance on how NFPOs would account for the forgiveness of related party financial assets and is seeking input from stakeholders on whether they agree that guidance is needed.

- The forgiveness of a financial asset due from management would be recognized as an expense in net income.

Modification and extinguishment of related party financial liabilities

- An enterprise would account for all modifications of a related party financial liability as an extinguishment of the original financial liability and the recognition of a new financial liability.

- NFPOs would recognize an extinguishment of a financial liability in accordance with CONTRIBUTIONS – REVENUE RECOGNITION, Section 4410.

Disclosure

- Requirements would be added to Section 3856 for an enterprise to disclose when it recognizes the forgiveness of a related party financial asset or extinguishment of a related party financial liability in net income because it was impracticable to determine whether the amount forgiven or extinguished originated in the normal course of operations.

- Modify the requirement to permit disclosures about significant risks arising from derivatives to be included with risks arising from other financial instruments, as opposed to requiring this disclosure to be illustrated separately.

Transition

- An enterprise would apply the proposals retrospectively, in accordance with ACCOUNTING CHANGES, Section 1506, with simplified transitional provisions.

Consequential amendments

As required, consequential amendments would be made to other standards in Part II of the Handbook.

Plans for finalizing the proposals

The Board will deliberate the proposals in light of comments received. Part of the deliberation process includes consultation with the Board's Private Enterprise Advisory Committee. The Private Enterprise Advisory Committee assists the Board in maintaining and improving accounting standards for private enterprises by providing input and recommendations on potential changes to the standards. The Board will also consult with:

- its Not-for-Profit Advisory Committee for input on circumstances that are unique to NFPOs when applying the potential changes to the standard; and

- other stakeholders through outreach activities, such as roundtables.

The Board will provide updates about its deliberations in its decision summaries and on the project page.

The Board plans to issue the final amendments in the fourth quarter of 2018, if no significant changes are required to the proposals after deliberating the comments received. In that case, the proposed effective date of the amendments would be for fiscal years beginning on or after January 1, 2020, with earlier application permitted.

Comments requested

Comments are most helpful if they relate to a specific paragraph or group of paragraphs. Any comments that express disagreement with the proposals in the Exposure Draft should clearly explain the problem and include a suggested alternative, supported by specific reasoning.

While the Board welcomes comments on all changes proposed in this Exposure Draft, it particularly welcomes comments on the questions listed below:

1. Do you agree that locating the initial measurement guidance for related party financial instruments in Section 3856 clarifies how the Section applies to the accounting for related party financial instruments? If not, why not?

2. Do you agree that the proposed consequential amendments to Section 3840 clarify how non-financial assets and non-financial liabilties (i.e., the assets and liabilties that are not in the scope of Section 3856) should be accounted for? If not, why not?

3. Do you agree that the initial cost of a related party financial instrument with repayment terms should be determined using the undiscounted cash flows of the instrument, excluding interest and dividends? If not, why not?

4. Do you agree that the initial cost of related party financial instruments without repayment terms should be determined as described in proposed paragraph 3856.08A(b)? If not, why not?

5. Do you agree that both investments in equity instruments of related parties that are quoted in an active market and derivative contracts with related parties should be initially and subsequently measured at fair value? If not, why not?

6. Do you agree that an enterprise should be prohibited from electing to subsequently measure related party financial instruments at fair value? In not, why not?

7. Do you agree that an enterprise should be permitted to initially measure the equity component of a related party compound financial instrument as zero? If not, why not?

8. Do you agree that an enterprise should first assess for, and recognize in net income, any impairment of a related party financial asset before a forgiveness of that financial asset is recognized? If not, why not?

9. Do you agree that an enterprise should recognize the forgiveness of related party financial assets in:

   (a) equity, when the original transaction that resulted in acquiring the asset was not in the normal course of operations; or

   (b) net income when the original transaction that resulted in acquiring the asset was in the normal course of operations or when it is impracticable to determine whether the amount forgiven originated in the normal or not in the normal course of operations?

   If not, why not?

10. Do you agree that NFPOs should be excluded from the scope of paragraph 3856.19A? If yes, do you think that NFPOs need guidance on how to account for the forgiveness of related party financial assets?

11. Do you agree that accounting for all modifications of related party financial liabilities as an extinguishment of the original financial liability and the recognition of a new financial liability, would simplify the accounting for these transactions? If not, why not?

12. Do you agree that an enterprise need not disclose significant risks arising from derivatives separately from risks arising from other financial instruments? If not, why not?

13. Do you agree that the proposals should be applied retrospectively in accordance with ACCOUNTING CHANGES, Section 1506, with simplified transitional provisions? If not, why not?

14. Do you agree with the proposed effective date (i.e., fiscal years beginning on or after January 1, 2020)? If not, why not?

The deadline for providing your comment letter to the Board is January 29, 2018. You may email your comments (Word format preferred) to info@acsbcanada.ca.

Basis for Conclusions

Introduction

1. This Basis includes the expected effects that the Board considered when developing the proposals in this Exposure Draft. The Board issued a Request for Comment, "Post-Implementation Review: Section 3856, Financial Instruments" in October 2014. The post-implementation review provided the Board an opportunity to assess the effects of the standard on financial statement users, preparers and practitioners, and considered whether:

   (a) Section 3856 provides financial statement information that is decision-useful to users of financial statements;

   (b) there are unexpected costs or challenges in applying the requirements of the standard; and

   (c) there are areas of the standard that present interpretation challenges and, as a result, affect its consistent application.

2. Overall, respondents of the post-implementation review supported the principles in the standard and most of its requirements. Respondents also shared their feedback and made recommendations to the Board to help it improve the standard's usefulness and application. A summary of all of the feedback received during the post-implementation review is available in the Feedback Statement the Board published in September 2015.

3. The Board sought input from its Private Enterprise Advisory Committee as to which issues raised by respondents merited being added to the Board's project plan. The Board used the following criteria when assessing the merit of addressing an issue:

   (a) Is the issue pervasive or acute ?

   (b) How important is the matter to those who use the financial statements?

   (c) Is there a deficiency in the way a particular type of transaction or activity is reported in the financial statements?

   (d) Are there alternative solutions?

   (e) Is there other guidance available outside the standard?

   (f) Would the cost of applying any new requirement exceed the benefit?

4. After applying these criteria and considering the input from the Private Enterprise Advisory Committee, the Board decided that several topics, in addition to those included in this project, should be added to its work plan. The Board placed priority on the topics addressed in this project because:

   (a) the scope, initial measurement of financial instruments originated or acquired, issued or assumed in a related party transaction and the usefulness of financial instrument risk disclosures were three of the most common issues raised by respondents to the post-implementation review;

   (b) the Board thought that a project addressing these narrow topics could be completed before a project addressing other issues; and

   (c) the other topics with merit would result in major projects requiring more time and resources to complete and therefore should be considered in the context of the Board's relative priorities for Part II projects.

5. The additional topics that have merit but have not been included in this project include:

   (a) *Fair value measurement*: to address concerns raised about the relevance of using fair value to initially measure financial instruments, and the challenges with doing so;

   (b) *Hedge accounting*: to consider expanding the hedging relationships that qualify for use of hedge accounting;

   (c) *Derecognition*: to address the challenges with applying the guidance related to the transfer of receivables and de-recognition of financial liabilities; and

   (d) *Classification of equity and financial liabilities*: to consider whether additional guidance is needed to determine the classification of financial liabilities, such as non-redeemable limited partnership units, limited life entities and general partnership interests that do not participate significantly in the earnings of the enterprise.

6. During the development of these proposals, the Board consulted its Private Enterprise Advisory Committee as well as various other stakeholders, including practitioners and users.

7. The Board understands that some stakeholders raised various issues regarding Section 3840. The objective of these proposals is to address concerns on the accounting for related party financial instruments. The Board is considering whether to undertake a project relating to Section 3840 in the context of its consultation with stakeholders about the relative priorities for Part II projects. Accordingly, the Board is currently undertaking research, including meeting with and talking to stakeholders regarding its priorities, and encourages stakeholders to provide input through its consultation page.

8. The Board also considered the consequences of applying these proposals relative to the objective of financial statements and the benefits versus cost constraint. As described in FINANCIAL STATEMENT CONCEPTS, paragraph 1000.12, the purpose of financial reporting is to "communicate information that is useful to investors, creditors and other users in making their resource allocation decisions and/or assessing management's stewardship." The Board thinks that the proposals will improve the relevance, understandability and comparability of financial reporting.

Applicability to NFPOs

9. NFPOs apply the standards for private enterprises in Part II of the Handbook to the extent that the Part II standards address topics not addressed in Part III. Therefore, NFPOs apply Section 3856 and, as a result, would be affected by these proposals. Accordingly, while developing the proposed amendments, the Board consulted with its Not-for-Profit Advisory Committee to understand circumstances that are unique to NFPOs when applying these proposals.

Effects analysis

10. The Board acknowledges that the proposals would result in a change in practice for some stakeholders. The Private Enterprise Advisory Committee and the Not-for-Profit Advisory Committee advised the Board that there is diversity in practice in accounting for related party financial instruments because the standards lack clarity or guidance. The Board thinks that the proposals would improve comparability in financial reporting for both the initial and subsequent accounting for related party financial instruments. Furthermore, the Board thinks that the proposals would reduce the effort of preparers to understand and apply the guidance.

11. The Board acknowledges that there may be costs to some private enterprises and NFPOs to communicate to financial statement users the effect of the changes on the financial statements. However, the Board expects that the costs of the proposals would be minimal because the proposals would:

(a) not significantly change current practice for most preparers; and

(b) improve clarity by simplifying current requirements.

Related party financial instruments

12. Related party transactions are accounted for in accordance with Section 3840, which is built on the premise that related parties do not necessarily transact at fair value. Therefore, the Board decided that the principles underlying Section 3840 should be considered when developing these proposals. These proposals reflect the following:

(a) the presumption in paragraph 3840.10 that a transaction between related parties cannot be presumed to have been entered into at fair value;

(b) related parties may enter into transactions that unrelated parties would not; and

(c) related party transactions should not result in the recognition of gains or losses in net income, unless otherwise permitted by Section 3840.

Initial measurement

Initial measurement of related party financial instruments

13. Currently, private enterprises refer to Section 3840 to initially measure related party financial instruments. Respondents to the post-implementation review expressed confusion as to whether related party financial instruments were in the scope of Section 3856 or Section 3840 after initial measurement. Stakeholders also informed the Board that it is difficult to apply the concepts in Section 3840 to newly issued or originated related party financial instruments.

14. NFPOs are excluded from the scope of Section 3840. Part III of the Handbook does not have a measurement standard for related party transactions. The Not-for-Profit Advisory Committee advised the Board that there is diversity in practice regarding the initial measurement of related party financial instruments as some organizations initially measure these instruments at fair value.

15. To address the concerns stakeholders raised, the Board proposes to include guidance on the initial measurement of related party financial instruments in Section 3856 rather than referring preparers to Section 3840. The Board thinks that moving the initial measurement guidance for related party financial instruments into Section 3856 would reduce confusion by providing one location for guidance on the initial measurement, subsequent measurement and derecognition of related party financial instruments.

16. The proposals are intended to result in the following:

(a) Private enterprises would refer to Section 3856 for all aspects of accounting for financial instruments. Furthermore, private enterprises would continue to refer to Section 3840 to determine whether the parties in the transaction are related, for the initial measurement of the non-financial instrument(s) exchanged in a transaction involving a related party financial instrument and the disclosure of related party transactions.

(b) Similar to private enterprises, NFPOs would refer to Section 3856 for all aspects of accounting for financial instruments. NFPOs would refer to:

(i) DISCLOSURE OF RELATED PARTY TRANSACTIONS BY NOT-FOR-PROFIT ORGANIZATIONS, Section 4460, to determine whether the parties in the transaction are related and for guidance on the disclosure of the related party transactions; and

(ii) CONTRIBUTIONS – REVENUE RECOGNITION, Section 4410, to account for the difference between the carrying amount of an extinguished related party financial liability and the consideration paid.

17. The Board decided that the initial measurement of most related party financial instruments should be consistent with the principles in Section 3840. The Board concluded that all related party financial instruments, excluding derivative contracts and investments in equity instruments that are quoted in an active market (which would be measured at fair value), should be initially measured at cost. Cost is a concept that is deeply rooted in accounting standards for private enterprises; however, the Board was concerned that the term "cost" is too broad and may lead to diversity in practice. Therefore, to provide further clarity, the Board has proposed guidance for the determination of the cost of related party financial instruments.

18. The Board decided that the cost of a related party financial instrument should be influenced by whether the instrument has repayments terms. Therefore, the proposals require an enterprise to determine first whether a related party financial instrument has repayment terms, and if it does, the cost of the instrument is determined using the undiscounted cash flow(s) of the instrument, excluding interest and dividend payments. The Board also decided that when a related party financial instrument does not have repayment terms, the cost of the instrument is determined (by the reporting enterprise for which the financial statements are being prepared) using the consideration transferred by the enterprise in the transaction.

19. In developing that decision, the Board considered several options for the initial measurement of related party financial instruments. The Board decided that initial measurement of related party financial instruments at cost, is preferable because:

(a) it does not require the determination of a market rate of the related party financial instrument at initial recognition; and

(b) related parties do not necessarily transact at fair value; therefore, it would be inappropriate to require the related party financial instrument to be initially measured at fair value.

20. To test the consistency of the application of the proposed initial measurement concepts, the Board conducted field testing. Participants applied the draft initial measurement principles to five different related party transactions involving financial instruments. The scenarios included the initial measurement of loans, retractable or mandatorily redeemable shares and common shares issued from one related party to another. For each scenario, the participants were asked to determine the amount at which the related party financial instrument would be initially measured. The Board considered the results of this testing when developing the proposals, including the addition of examples illustrating the application of the proposed guidance to simplify use of the standard for preparers.

Interaction between this Exposure Draft and the "Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement" Exposure Draft

21. The Board recently issued its Exposure Draft, "Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement (Proposed amendments to Section 1591, 3251 and 3856)," which focuses on the balance sheet classification and measurement of retractable or mandatorily

redeemable shares issued in a tax planning arrangement. The Exposure Draft “Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement,” does not distinguish between tax planning arrangements involving related and arm’s length parties.

22. This Exposure Draft addresses the initial and subsequent measurement of all related party financial instruments, excluding retractable or mandatorily redeemable shares issued in a tax planning arrangement that are classified as financial liabilities, which are in the scope of the Exposure Draft “Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement (Proposed amendments to Sections 1591, 3251 and 3856).”

23. Before drafting either Exposure Draft, the Board decided that all retractable or mandatorily redeemable shares issued in a tax planning arrangement that are classified as a financial liability would be initially measured at the redemption amount.

24. The Board plans to issue at the same time the final amendments to Section 3856 and is proposing the same effective date, in both Exposure Drafts. Therefore, when finalizing the amendments in respect of the proposals in the two Exposure Drafts, the Board will ensure that the amendments to Section 3856 reflect the Board’s intent.

Subsequent measurement

25. To simplify the use of the standard, the Board decided that the subsequent measurement of related party financial instruments should align with its initial measurement conclusions. Therefore, the proposals require an enterprise to subsequently measure:

    (a) investments in equity instruments that are quoted in an active market and derivative contracts at fair value; and

    (b) all other related party financial instruments at cost, less any reduction for impairment.

26. The Board thinks that subsequently measuring investments in equity instruments of related parties that are quoted in an active market and derivative contracts at fair value is preferable because:

    (a) it provides relevant and reliable information to financial statement users; and

    (b) subsequently measuring a derivative contract at cost would result in the instrument being accounted for off-balance sheet and delay the recognition of any gain or loss on the instrument until it is settled.

27. The Board decided to preclude an enterprise from electing to measure any related party financial instrument at fair value. Therefore, the proposals require an enterprise to discontinue measuring an investment in an equity instrument of a related party at fair value, when the instrument ceases to be quoted in an active market.

28. Subsequent measurement relating to retractable or mandatorily redeemable preferred shares issued in a tax planning arrangement is addressed in the Exposure Draft “Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement (Proposed Amendments to Sections 1591, 3251 and 3856).”

Measurement of compound financial instruments

29. Private Enterprise Advisory Committee members and respondents to the post-implementation review thought it was unclear whether the guidance in paragraph 3856.22 is available for the initial measurement of the separate liability and equity components of related party compound financial instruments.

30. The Private Enterprise Advisory Committee informed the Board that the equity component of a related party compound financial instrument is often initially measured at a nominal amount ($1) or zero.

31. The Board agreed that an enterprise should be permitted to initially measure the equity component of a related party compound financial instrument as zero consistent with the acceptable methods used for the initial measurement of compound financial instruments issued in an arm's length transaction.

Classification of impairment and forgiveness of related party financial assets

32. Private Enterprise Advisory Committee members and respondents to the post-implementation review thought that the accounting for the impairment of related party financial assets that are subsequently forgiven is unclear. They questioned whether both the impairment and subsequent forgiveness should be accounted for in net income or equity. They also noted that it is sometimes difficult to differentiate between the impairment and forgiveness of a related party financial asset.

33. The Board decided that an enterprise should first assess and recognize an impairment of a related party financial asset before recognizing any forgiveness of the financial asset. The Board also agreed that the indicators of impairment of a financial asset in paragraph 3856.A15 apply to a related party financial asset and that the impairment should be recognized in net income. The Board also decided that the impairment assessment for related party financial assets would use the higher of the undiscounted cash flows expected to be generated by holding the asset, excluding the interest and dividend payments of the instrument and the amounts specified in sub-paragraph 3856.17(b)-(c).

34. Financial statement users informed the Board that:

    (a) acquirers commonly use net income and other income statement metrics (including earnings before interest, taxes, depreciation and amortization) to value acquisitions; and

    (b) they classify the forgiveness of a related party financial asset based on the original nature of the transaction that gave rise to the financial asset, in an effort to avoid the overstatement or understatement of the income metric being used to value the acquisition.

35. Therefore, the Board decided that the forgiveness of the related party financial asset should be recognized in net income when the original transaction that gave rise to the financial asset was in the normal course of the enterprise's operations; and in equity when the original transaction was not in the normal course of the enterprise's operations.

36. The Board received feedback from its Private Enterprise Advisory Committee that, in practice, related party accounts receivable often include a mixture of transactions (normal and non-normal course), and that there may not be an objective way to identify the nature of cash flows in these accounts. Therefore, the Board decided that the forgiveness of a related party financial asset should be recognized in net income when it is impracticable to determine whether the amount forgiven originated outside the normal course of operations. The Board also decided that if an enterprise recognizes the forgiveness in net income as the result of the enterprise applying the proposed criteria in paragraph 3856.19A(b)(ii), it would disclose that fact and the nature of the transactions that gave rise to financial asset forgiven.

37. The Not-for-Profit Advisory Committee comfirmed for the Board that NFPOs recognize the forgiveness of related party financial assets in the statement of operations because they do not have equity. Therefore, the Board decided to exclude NFPOs from the scope of the proposals in paragraphs 3856.19A and 3856.47A.

38. The Board also decided that when an enterprise forgives a financial asset due from a related party whose sole relationship with the enterprise is in the capacity of management, the forgiveness of a financial asset is compensation. Therefore, the forgiveness of the financial asset should be recognized as an expense in net income consistent with other forms of compensation.

Modification and extinguishment of related party financial liabilities

39. The Board recognizes that:

    (a) the guidance in paragraph 3856.A52 refers to the present value of future cash flows to determine whether the terms of a renegotiated financial liability differ substantially from the original financial liability; and

    (b) related party financial instruments are initially measured in accordance with Section 3840 and recognized at either carrying or exchange amount, without reference to the present value of future cash flows.

    Stakeholders informed the Board that it is challenging to apply paragraph 3856.A52 to the modification of related party financial liabilities because the measures in paragraphs (a) and (b) above are inconsistent.

40. The Private Enterprise Advisory Committee informed the Board that:

    (a) the most common renegotiation of related party financial liabilities includes changes to the interest rate of the instrument or its maturity date; and

    (b) it is unlikely that the modification of a related party financial liability would result in an extinguishment, unless the enterprise forgives part of the financial liability.

41. The renegotiation of the discount rate or term of the financial liability would not change the cost of the financial liability. Therefore, there would not be a difference between the carrying amount of the derecognized financial liability and the new financial liability. Alternatively, renegotiations of a financial liability that result in a difference between the carrying amount of the derecognized financial liability and the initial measurement of the new financial liability would be recognized immediately with the difference accounted for in accordance with the proposal in paragraph 3856.28A. The Board also decided that if an enterprise recognizes the extinguishment in net income as the result of the enterprise applying the proposed criteria in paragraph 3856.28A(b)(ii), it would disclose that fact and the nature of the transactions that gave rise to financial liability extinguished.

42. At first glance, the Board's proposal to require an enterprise to account for all modifications of a related party financial liability as an extinguishment may seem onerous. However, the Board thinks, when considered in the context of its proposals for the initial measurement of related party financial instruments, that the proposal would be less challenging to apply compared to existing requirements.

43. The Board also decided that in the case of NFPOs, the resulting gain or loss on an extinguishment of a financial liability meets the definition of a contribution and should be accounted for in accordance with CONTRIBUTIONS — REVENUE REGOGNITION, Section 4410 of Part III of the Handbook. Accordingly, NFPOs are excluded from the scope of the proposals in paragraphs 3856.28A, 3856.42A and 3856.A58A.

44. The Private Enterprise Advisory Committee and the respondents to the post-implementation review informed the Board that the guidance in paragraph 3856.A52 is challenging to apply to both related party and arm's length financial instruments. This Exposure Draft proposes that the guidance in paragraph 3856.A52 would no longer be applicable for modifications of related party financial liabilities. Based on the result of its priorities consultation, the Board will consider whether a project may be added to its project plan related to paragraph 3856.A52 and the modification of financial liabilities between parties that transact at arm's length.

Disclosure

45. Respondents to the post-implementation review expressed concerns that some financial instrument information disclosed in the notes to the financial statements, particularly the significant risk disclosure note, is not useful to users. Furthermore, respondents commented that financial instrument risk information disclosed in the notes to the financial statements is often boilerplate and not entity-specific. The Private Enterprise Advisory Committee informed the Board that:

    (a) some of the information disclosed in the financial instrument risk note, including how a risk arose, is obvious based on the nature of the instrument and can be observed on the face of the financial statements; and

    (b) preparers do not understand what is meant by “significant risk” in paragraph 3856.53.

46. The Board is aware that there are multiple users of private enterprise and NFPO financial statements. Therefore, when developing these proposals, the Board consulted different types of financial statement users regarding the usefulness of the risk disclosures for financial instruments. The Board asked users what information they found useful when making their resource allocation decisions. Overall, these users thought that financial instrument risk disclosure is useful when it is entity-specific and explains the enterprise’s current exposure to risk.

47. The Board thinks that removing the requirement to disclose how a significant financial instrument risk arose will reduce the usefulness of the financial statements. The Board is concerned that some financial statement users rely on this information to understand the nature of the financial instrument risks to which an enterprise is exposed.

48. The Board understands that it may be challenging to determine whether a risk arising from a financial instrument is significant. However, it encourages preparers to apply judgment when assessing whether a risk that arises from a financial instrument is significant.

49. Therefore, the Board decided that the current disclosure requirements are appropriate and encourages enterprises to prepare their financial instrument risk note disclosures using entity-specific information.

50. The Board’s role as a standard setter is to set accounting requirements for Canadian enterprises that results in providing financial information that enables investors, lenders and other creditors to make informed investing and lending decisions. The Board thinks that relevant disclosures result from preparers:

    (a) disclosing significant risks that arise from financial instruments when the enterprise has an exposure to that risk; and

    (b) excluding such disclosure when the risks arising from financial instruments are not considered significant based on the enterprise’s current exposure.

51. Financial statement users informed the Board that disclosure of financial instrument risk and uncertainty about derivatives is useful, but that this disclosure does not need to be provided separately from other financial instruments. After considering this input from users, the Board decided that significant risks arising from derivatives should be provided, although it need not be done separately.

Transition

52. The Private Enterprise Advisory Committee informed the Board that most of the proposals would not have a significant effect on preparers since they would not lead to changes in practice. Furthermore, the Not-for-Profit Advisory Committee did not identify any circumstances unique to NFPOs that would indicate that the proposals would lead to significant changes in practice. However, for some of the

proposals, the Board thinks there may be a change in practice and proposes to provide some relief when applying these amendments for the first time.

53. The proposed transition guidance would not require an enterprise to remeasure a financial instrument that does not exist on the date that the amendments are first applied. For example, a financial liability that was settled or extinguished in the period before that date would not be remeasured.

54. In addition, the Board was concerned with the transitional implications of the proposal to measure a financial instrument that does not have repayment terms using the consideration transferred by the enterprise in the transaction. An example of such an instrument would be a common share investment acquired in exchange for land. The Board thinks it might be impracticable to remeasure the common share investment in accordance with these proposals, particularly if the transaction occurred several years ago. Therefore, the Board decided to not require remeasurement of a financial instrument that is measured using the consideration transferred by the enterprise, in accordance with paragraph 3856.08(b).

55. The Board also noted a financial instrument that exists on the date the amendments are first applied may have been modified or a portion extinguished in the period preceding that date. In such situations, the proposals relating to modifications and extinguishments of related party financial instruments would be applied as of the beginning of the earliest period presented.

Effective date

56. The Board's view is that the proposed effective date, being fiscal years beginning on or after January 1, 2020, would allow sufficient time for preparers to implement the proposed changes and to educate users on the proposals. The Board also proposes that the effective date of these amendments be the same as the amendments relating to the Exposure Draft "Retractable or Mandatorily Redeemable Shares issued in a Tax Planning Arrangement (Proposed amendments to Sections 1591, 3251 and 3856)" and that preparers would be permitted to early adopt the amendments.

Consequential amendments

57. The proposed changes would have an effect on other Sections. The rationale for some of the more significant amendments are described throughout the Basis.

Conclusion

58. Having considered the effects of the proposed changes discussed above, the Board believes that the positive effects of the proposals will outweigh any negative effects and that the proposals will result in improvements to financial reporting for private enterprises and NFPOs.

Accounting for Related Party Financial Instruments and Significant Risk Disclosures – Proposed Amendments to FINANCIAL INSTRUMENTS, Section 3856

PROPOSAL

The following Sections would be amended as indicated below. Additional text is denoted by underlining and deleted text by strikethrough.

FINANCIAL INSTRUMENTS, Section 3856

PURPOSE AND SCOPE

…

.03 An entity applies this Section to all financial instruments arising from transactions between arm's length and related parties, except the following:

…

.04 This Section does not apply to:

(a) contracts to buy or sell non-financial items except for:

(i) exchange-traded futures contracts; and

(ii) contracts that are designated in a qualifying hedging relationship in accordance with paragraphs 3856.30-.36.; and

(b) non-financial assets and non-financial liabilities (i.e. assets and liabilities that are excluded from the Scope of this Section) in related party transactions (see RELATED PARTY TRANSACTIONS, Section 3840).

.04A Not-for-profit organizations do not apply paragraphs 3856.19A, 3856.28A, 3856.42A, 3856.47A and 3856.A58A. The extinguishment of related party financial liabilities by not-for-profit organizations is accounted for in accordance with CONTRIBUTIONS – REVENUE RECOGNITION, Section 4410.

DEFINITIONS

…

.05(b)(i) **Carrying amount** is the amount of an item transferred, or cost of services provided, as recorded in the accounts of the transferor, after adjustment, if any, for amortization or impairment in value.

…

.05(e)(i) **Exchange amount** is the amount of consideration paid or received as established and agreed to by related parties.

…

.05(o)(i) **Related parties** exist when one party has the ability to exercise, directly or indirectly, control, joint control or significant influence over the other. Two or more parties are related when they are subject to common control, joint control or common significant influence. Related parties also include management and immediate family members (see RELATED PARTY

TRANSACTIONS, paragraph 3840.04).

.05(o)(ii) A **related party transaction** is a transfer of economic resources or obligations between related parties, or the provision of services by one party to a related party, regardless of whether any consideration is exchanged. The parties to the transaction are related prior to the transaction. When the relationship arises as a result of the transaction, the transaction is not one between related parties.

…

MEASUREMENT

Initial measurement

.06A *Except as specified in this Section, transaction costs shall be recognized in net income in the period incurred.*

Arm's length transactions

.07 *Except as specified in paragraph 3856.09A~~8A~~, ~~W~~when a financial asset is originated or acquired or a financial liability is issued or assumed in an arm's length transaction, an ~~entity~~ enterprise shall measure it at its fair value adjusted by, in the case of a financial asset or financial liability that will not be measured subsequently at fair value, financing fees and transaction costs that are directly attributable to its origination, acquisition, issuance or assumption.* (Paragraphs 3856.A8-.A13 provide related application guidance.)

Related party transactions

.08 *Except as specified in paragraphs 3856.08C and ~~-~~3856.09~~8~~A, ~~W~~when a financial asset is originated or acquired or a financial liability is issued or assumed in a related party transaction, ~~an entity~~ the initial measurement of the financial instrument shall be cost. The cost of a financial instrument in a related party transaction shall depend on whether the instrument has repayment terms. When the financial asset originated or acquired, or the financial liability issued or assumed: ~~measure it in accordance with RELATED PARTY TRANSACTIONS, Section 3840.~~*

(a) has repayment terms, the cost of the instrument shall be determined using the undiscounted cash flow(s), excluding interest and dividend payments, of the instrument.

(b) does not have repayment terms, the cost of the instrument shall be determined using the consideration transferred by the enterprise in the transaction.

.08A As required by paragraph 3856.08(b), when the consideration transferred by the enterprise in the transaction:

(a) is a financial instrument that has repayment terms, the cost of the financial asset originated or acquired or the financial liability issued or assumed is determined using the undiscounted cash flow(s), excluding interest and dividend payments, of the financial instrument transferred as consideration.

(b) does not have repayment terms, the cost of the financial asset originated or acquired or the financial liability issued or assumed is the exchange amount of the consideration transferred when:

(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 item transferred is substantive; and*

(iii) *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 originated or acquired or the financial liability issued or assumed in a related party transaction is the carrying amount of the consideration transferred.

(Paragraphs 3856.A8A and 3856.A8B provide related application guidance.)

.08B *When a related party transaction is measured at the exchange amount, any gain or loss resulting from the transaction shall be included in net income, unless another Section requires alternative treatment.*

.08C *An enterprise shall initially measure the following related party financial instruments at fair value without any adjustments:*

(a) *investments in equity instruments that are quoted in an active market; and*

(b) *derivative contracts.*

.09 For the purpose of this Section, parties whose sole relationship with the entity is in the capacity of management, as defined in RELATED PARTY TRANSACTIONS, paragraph 3840.04(d), as an individual, group or by contract, and members of the immediate family of any individual to which this paragraph applies, are deemed to be unrelated third parties. The requirements of paragraph 3856.07 apply to transactions with such parties.

Retractable or mandatorily redeemable shares issued in a tax planning arrangement

.09A~~8A~~[2] *For retractable or mandatorily redeemable shares issued in a tax planning arrangement and classified as a financial liability in accordance with paragraph 3856.23, an enterprise shall measure the financial liability at its redemption amount.*

~~.10~~ ~~*Except as specified in this Section, transaction costs shall be recognized in net income in the period incurred.*~~ (deleted)

Subsequent measurement and income recognition

Arm's length transactions

.11 *Except as specified in paragraphs 3856.12-14, at each reporting date, an ~~entity~~ enterprise shall measure:*

(a) *investments in equity instruments of arm's length parties at cost less any reduction for impairment;*

(b) *all other arm's length financial assets at amortized cost; and*

[2] Currently open for comment is the Board's Exposure Draft "Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement (Proposed amendments to Section 1591, 3251 and 3856)" to address the balance sheet classification of such shares. This Exposure Draft illustrates, using double underline, some of the proposals in that Exposure Draft.

(c) arm's length financial liabilities at amortized cost.

.12 *An ~~entity~~ enterprise shall measure the following arm's length financial instruments at fair value without any adjustment for transaction costs it may incur on sale or other disposal:*

(a) investments in equity instruments that are quoted in an active market (see paragraphs 3856.A9-.A11); and

(b) derivative contracts other than:

(i) derivatives that are designated in a qualifying hedging relationship in accordance with paragraphs 3856.30-.36 or FOREIGN CURRENCY TRANSLATION, paragraph 1651.39; and

(ii) derivatives that are linked to, and must be settled by delivery of, equity instruments of another ~~entity~~ enterprise whose fair value cannot be readily determined.

Changes in fair value shall be recognized in net income in the period incurred.

.13 *Except for a financial instrument to which paragraph 3856.09A~~8A~~ applies, ~~An entity~~ an enterprise may elect to measure any arm's length financial asset or financial liability at fair value by designating that fair value measurement shall apply:*

(a) when the asset or liability is first recognized in accordance with this Section; or

(b) for an investment in an equity instrument that was previously measured at fair value in accordance with paragraph 3856.12(a), when the instrument ceases to be quoted in an active market.

Any designation in accordance with this paragraph is irrevocable.

.14 *The issuer of a financial liability that is indexed to a measure of the ~~entity~~ enterprise's financial performance or to changes in the value of the ~~entity~~ enterprise's equity shall account for the instrument as follows:*

(a) the liability is initially measured in accordance with paragraph 3856.07 ~~or 3856.08~~;

(b) interest expense is calculated using the stated interest rate, plus or minus the amortization of any initial premium or discount; and

(c) at each reporting date, the ~~entity~~ enterprise adjusts the carrying amount of the liability to the higher of:

(i) the amortized cost of the debt; and

(ii) the amount that would be due at the balance sheet date if the formula determining the additional amount was applied at that date (the conversion or intrinsic value).

The amount of the adjustment in accordance with paragraph (c) above shall be recognized in net income and presented as a separate component of interest expense.

.15 *An ~~entity~~ enterprise shall report interest, dividends, losses and gains relating to an arm's length financial instrument, or a component part that is classified as a financial liability in net income as expense or income. The issuer shall report distributions to holders of a financial instrument it classifies as an equity instrument directly in equity.*

(Paragraphs 3856.A39-.A40 provide related application guidance.)

Related party transactions

.15A *Except as specified in paragraph 3856.15B, at each reporting date, an enterprise shall measure all related party financial instruments at cost less any reduction for impairment.*

.15B *An enterprise shall measure the following related party financial instruments at fair value without any adjustment* for transaction costs it may incur on sale or other disposal:

(a) *investments in equity instruments that are quoted in an active market* (see paragraphs 3856.A9-.A10)*; and*

(b) *derivative contracts, other than:*

(i) derivatives that are designated in a qualifying hedging relationship in accordance with paragraphs 3856.30-.36 or FOREIGN CURRENCY TRANSLATION, paragraph 1651.39; and

(ii) derivatives that are linked to, and must be settled by delivery of, equity instruments of another entity enterprise whose fair value cannot be readily determined.

Changes in fair value shall be recognized in net income in the period incurred.

.15C *An enterprise discontinues measuring an investment in an equity instrument of a related party at fair value, when the instrument ceases to be quoted in an active market. The fair value of the instrument, immediately before the instrument ceases to be quoted in an active market, is the cost of the instrument.*

.15D *Except as specified in paragraphs 3856.19A and 3856.28A, an enterprise shall report interest, dividends, losses and gains related to a related party financial instrument, or component part that is classified as a financial liability in net income as expense or income. The issuer shall report distributions to holders of a financial instrument it classifies as an equity instrument directly in equity.*

Impairment

.16 *At the end of each reporting period, an ~~entity~~ enterprise shall assess whether there are any indications that a financial asset, or group of similar financial assets, measured at cost or amortized cost may be impaired. When there is an indication of impairment, an ~~entity~~ enterprise shall determine whether a significant adverse change has occurred during the period in the expected timing or amount of future cash flows from the financial asset or group of assets. (Paragraphs 3856.A14-A21 provide related application guidance.)*

.17 *Except as specified in paragraph 3856.17A, ~~W~~when an ~~entity~~ enterprise identifies a significant adverse change in the expected timing or amount of future cash flows from a financial asset, or group of similar financial assets, it shall reduce the carrying amount of the asset, or group of assets, to the highest of the following:*

(a) the present value of the cash flows expected to be generated by holding the asset, or group of assets, discounted using a current market rate of interest appropriate to the asset, or group of assets;

(b) the amount that could be realized by selling the asset, or group of assets, at the balance sheet date; and

(c) the amount the ~~entity~~ enterprise expects to realize by exercising its right to any collateral

held to secure repayment of the asset, or group of assets, net of all costs necessary to exercise those rights.

The carrying amount of the asset, or group of assets, shall be reduced directly or through the use of an allowance account. The amount of the reduction shall be recognized as an impairment loss in net income.

.17A *In a transaction between related parties, an enterprise shall reduce the carrying amount of the asset or group of assets, to the highest of the undiscounted cash flows expected to be generated, by holding the asset, or group of assets, excluding the interest and dividend payments of the instrument, and the amounts specified in subparagraphs 3856.17(b)–(c).*

…

Forgiveness

.19A *After assessing for and recognizing any impairment in accordance with paragraph 3856.17A, forgiveness of a related party financial asset shall be recognized in:*

(a) equity, when the original 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 original 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 amount forgiven was originated or was acquired in the normal or not in the normal course of operations.

When an enterprise forgives a related party financial asset due from a counterparty that is acting solely in the capacity of management, the transaction is considered compensation and shall be recognized as an expense, by the enterprise, in net income.

A borrower accounts for the extinguishment of a related party financial liability in accordance with paragraph 3856.28A.

(Paragraph 3856.A21A provides related application guidance.)

PRESENTATION

Investments

.19~~A~~B *Income from investments measured at fair value, and investments measured at cost shall be separately presented on the face of the income statement.*

PRESENTATION

Liabilities and equity

Arm's length transactions

.21 *The issuer of a financial instrument that contains both a liability and an equity element, including warrants or options issued with and detachable from a financial liability, shall* *classify the instrument's component parts separately in accordance with paragraph 3856.20.* (Paragraphs 3856.A30–.A38 provide related application guidance.)

.22 Acceptable methods for initial measurement of the separate liability and equity elements of an instrument issued in an arm's length transaction to which paragraph 3856.21 applies include the following:

(a) The equity component is measured as zero. The entire proceeds of the issue are allocated to the liability component.

(b) The less easily measurable component is allocated to the residual amount after deducting from the entire proceeds of the issue the amount separately determined for the component that is more easily measurable.

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. No gain or loss arises from recognizing and presenting the components of the instrument separately.

Related party transactions

.22A Acceptable methods for initial measurement of the separate liability and equity elements of an instrument issued in a related party transaction, to which paragraph 3856.21 applies, include the following:

(a) The equity component is measured as zero. The entire proceeds of the issue are allocated to the liability component.

(b) 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.

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.

Retractable or mandatorily redeemable shares issued in a tax planning arrangement

…

DERECOGNITION

…

Financial liabilities

.26 *An ~~entity~~ enterprise shall remove a financial liability (or part of a financial liability) from its balance sheet when it is extinguished (i.e., when the obligation is discharged or cancelled, or expires).* (Paragraphs 3856.A49-.A61 provide related application guidance.)

.27 Except as specified in paragraph 3856.27A, a ~~A~~ transaction between a borrower and lender to replace a debt instrument with another instrument having substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability

.27A A transaction between related parties to replace a debt instrument with another financial 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 liability.

.28 *Except as specified in paragraph 3856.28A, ~~T~~ the difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the fair value of the consideration paid, including any non-cash assets transferred, liabilities assumed or equity instruments issued, shall be recognized in net income for the period.* ~~(A transaction with a related party, is accounted for in accordance with RELATED PARTY TRANSACTIONS, Section 3840.)~~

.28A *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 paragraph 3856.19A.

(Paragraph 3856.A58A provides related application guidance.)

…

DISCLOSURE

...

Forgiveness

.42A *If an enterprise recognizes the forgiveness of a related party financial asset in net income, as a result of applying the criteria in paragraph 3856.19A(b)(ii), it shall disclose that fact and the nature of the transactions that gave rise to the financial asset.*

Financial liabilities

…

.47A *If an enterprise recognizes the extinguishment of a related party financial liability in net income, as the result of applying the criteria in paragraph 3856.28A(b)(ii), it shall disclose that fact and* *the nature of the transactions that gave rise to the financial liability.*

…

Risks and uncertainties

.53 *For each significant risk (see paragraph 3856.A66) arising from financial instruments, including ~~and separately for~~ derivatives, an enterprise shall disclose:*

(a) the exposure to risk and how they arose; and

(b) any change in the risk exposures from the previous period.

…

EFFECTIVE DATE AND TRANSITION

.55 Except as specified in paragraphs 3856.56-.62~~1~~, this Section applies to annual financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier application is permitted

…

.62[3] Amendments to paragraphs 3856.03-.04, 3856.07-.08, 3856.11-.15, 3856.17, 3856.19B, 3856.22, 3856.27-.28, 3856.53, 3856.A8, 3856.A30, 3856.A35-.A36, 3856.A54, 3856.A56, 3856.A58-.A61 and new paragraphs 3856.04(b), 3856.04A, 3856.05(b)(i), 3856.05(e)(i), 3856.05(o)(i), 3856.05(o)(ii), 3856.06A, 3856.08A-.08C, 3856.09A, 3856.15A-.15D, 3856.17A, 3856.19A, 3856.22A, 3856.27A, 3856.28A, 3856.42A, 3856.47A, 3856.A8A, 3856.A8B, 3856.A21A, 3856.A37A, 3856.A37B and 3856.A58A, issued in XXXX 201X, apply to annual financial statements relating to fiscal years beginning on or after January 1, 2020. An enterprise applies these amendments retrospectively in accordance with ACCOUNTING CHANGES, Section 1506, except as specified in paragraphs 3856.63-.64. Earlier application is permitted.

.63 Except as specified in paragraph 3856.64, an enterprise applies the amendments relating to paragraphs 3856.08, 3856.08A, 3856.08C and 3856.A8A-.A8B to related party financial instruments that exist at the date these amendments are applied for the first time as follows:

(a) When the related party financial instrument has repayment terms, the cost of instrument is determined using the undiscounted cash flow(s), excluding interest and dividend payments, of the instrument as at the beginning of the fiscal year immediately preceding the date at which the amendments are applied for the first time.

(b) When the related party financial instrument does not have repayment terms, the cost of the instrument is deemed to be the carrying amount of the instrument in the financial statements of the enterprise at the beginning of the fiscal year immediately preceding the date at which the amendments are applied for the first time.

(c) When the related party financial instrument is an investment in an equity instrument that is quoted in an active market or a derivative contract, the instrument is measured using its fair value at the beginning of the fiscal year immediately preceding the date at which the amendments are applied for the first time.

.64 An enterprise need not restate a related party financial instrument that does not exist at the date

[3] There is currently the Exposure Draft "Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement (Proposed amendments to Section 1591, 3251 and 3856)" that also contains transitional provisions using the same paragraph numbers. Accordingly, the paragraph numbers may change when these amendments are finalized.

these amendments are applied for the first time and was impaired, modified or extinguished in the immediately preceding fiscal year. When a related party financial instrument exists at the date these amendments are applied for the first time and was impaired, modified or extinguished in the immediately preceding fiscal year, the enterprise applies:

(a) paragraph 3856.63 to a related party instrument that exists at the beginning of the earliest period presented; and

(b) then accounts for any impairment, modification or extinguishment by applying the Section.

APPENDIX A

MEASUREMENT

Initial measurement

A8 When part of the consideration given or received in a transaction to acquire or issue a financial instrument in an arm's length transaction is for something other than the financial instrument, its fair value is estimated using a valuation technique…

A8A A contract may be written or oral. Examples of financial instruments having repayment terms include:

(a) trade accounts receivable and payable;

(b) notes receivable and payable;

(c) loans receivable and payable;

(d) bonds receivable and payable; and

(e) retractable or mandatorily redeemable shares.

A8B Examples of financial instruments that do not have repayment terms include:

(a) common shares;

(b) warrants;

(c) preferred shares that do not have a stated redemption amount; and

(d) options.

…

MEASUREMENT

Impairment

…

A15 Indicators of impairment include:

(a) significant financial difficulty of the customer or issuer;

(b) a breach of contract, such as a default or delinquency in interest or principal payments;

(c) the entity granting a concession to the customer or issuer;

(d) it becoming probable that the customer or issuer will enter bankruptcy or other financial reorganization;

(e) the disappearance of an active market for a financial asset because of financial difficulties of the issuer;

(f) a significant adverse change in the technological, market, economic or legal environment in which the customer or issuer operates (for example, a sharp decline in the price of a commodity, such as oil or lumber, may cause economic instability in the related industry or have an adverse effect on other customers in a region that is dependent on the particular industry); and

(g) adverse national or local economic conditions or adverse changes in industry conditions indicate that there is a decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group.

…

FORGIVENESS

A21A A related party financial asset is forgiven when the enterprise terminates all or part of a liability for payment to settle the financial asset. Cancellation, set-off and release are examples of possible means of termination.

LIABILITIES AND EQUITY

…

A30 Paragraph 3856.20 requires the separate presentation on an issuer's balance sheet of liability and equity elements created by a single financial instrument. It is more a matter of form than substance that both liabilities and equity interests are created by a single financial instrument rather than two or more separate instruments. Consequently, the same accounting applies whether the liability and equity interests are created by a single instrument or by two or more separate but linked instruments (see paragraphs 3856.21-.22A). An issuer's financial position is more faithfully represented by separate presentation of the liability and equity components contained in a single instrument according to their nature.

…

Accounting for convertible debt instruments

...

A35 When an option to convert an arm's length financial liability to equity is exercised and the issuer settles the obligation in cash, the ~~entity~~ enterprise accounts for the settlement as the extinguishment of the instrument, and a gain or loss on extinguishment of the liability element is recognized in net income (see paragraphs 3856.20-.23, and 3856.A49-.A61). The settlement of the equity element is recognized as a capital transaction (see CAPITAL TRANSACTIONS, Section 3610), 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.

A36 On extinguishment of an arm's length convertible debt instrument, the issuer allocates the consideration paid to the liability and equity elements as follows:

(a) When the initial measurement of the equity element was zero in accordance with paragraph 3856.22(a), the consideration is allocated first to the liability, up to the carrying amount of the debt, including accrued interest, and the balance, if any, to the equity element.

(b) When the initial measurement of the liability and equity elements was based on measuring one or both components at its fair value in accordance with paragraph 3856.22(b), the consideration is allocated on the same basis as that used in the original allocation of the proceeds received by the ~~entity~~ enterprise on issuance of the convertible instrument.

A37 When the issuer 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 amount of gain or loss relating to the liability element is credited or charged to income; and

(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.

A37A 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, and any difference on extinguishment of the liability element is recognized in accordance with paragraph 3856.28A. The settlement of the equity element is recognized as a capital transaction (see CAPITAL TRANSACTIONS, Section 3610), 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.

A37B On extinguishment of a related party convertible debt instrument, the issuer allocates the consideration paid to the liability and equity elements as follows:

(a) When the initial measurement of the equity element was zero in accordance with paragraph 3856.22A(a), the consideration is allocated first to the liability, up to the carrying amount of the debt, including accrued interest, and the balance, if any, to the equity element.

(b) When the initial measurement of the liability component was measured in accordance with paragraph 3856.22A(b), the consideration is allocated on the same basis as that used in the original allocation of the proceeds received by the enterprise on issuance of the convertible instrument.

A38 If an option to convert a financial liability to equity is not exercised and the conversion option expires at maturity, the issuer accounts for the settlement of the instrument at its redemption value (which, at that time, is also the stated principal amount of the instrument). Accordingly, the liability element is derecognized, and the carrying amount of the equity element, if any, is transferred to contributed surplus. If the entity enterprise settles the debt element through issuance of shares, the redemption value of the debt element is credited to share capital.

DERECOGNITION OF FINANCIAL LIABILITIES

…

A52 For the purpose of paragraph 3856.27, the terms of a renegotiated financial liability differ substantially from the original liability when:

(a) the present value of the cash flows under the new terms, including any fees paid net of any fees received differs by at least 10 percent from the present value of the remaining cash flows of the original financial liability, both discounted at the original interest rate; or

(b) there is a change in the creditor and the original debt is legally discharged by the debtor through a cash payment or otherwise.

…

A54 When an exchange of debt instruments (exchange) or a modification of the terms of a financial liability (modification) issued in an arm's length transaction is accounted for as an extinguishment in accordance with paragraph 3856.26, the debtor accounts for the difference between:

(a) the fair value of the new debt instrument; and

(b) the carrying amount of the original debt instrument (together with all unamortized financing fees and transaction costs accounted for as adjustments to the original debt instrument).

as a gain or loss in net income.

…

A56 For the purpose of paragraph 3856.26, the terms of a renegotiated line of credit or revolving debt arrangement issued in an arm's length transaction differ substantially from the original liability when the product of the remaining term and the maximum available credit (the borrowing capacity) of the old arrangement exceeds the borrowing capacity of the new arrangement.

…

A58 Except as specified in paragraph 3856.A58A, I~~i~~n some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In this circumstance, the debtor:

(a) recognizes a new financial liability based on the fair value of its obligation under the guarantee; and

(b) recognizes a gain or loss based on the difference between:

(i) any amounts paid; and

(ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

A58A When the debtor and creditor are related parties, the debtor:

(a) recognizes a new financial liability based on the amount measured in accordance with paragraph 3856.08; and

(b) recognizes the difference between:

(i) any amounts paid; and

(ii) the carrying amount of the original financial liability less the amount of the new financial liability.

in equity or net income in accordance with paragraph 3856.28A.

A59 The issue of an ~~entity's~~ enterprise's equity instruments to a creditor to extinguish all or part of a financial liability is consideration paid in accordance with paragraphs 3856.28 and 3856.28A.

A60 An enterprise initially measures equity instruments issued to a creditor in an arm's length transaction to extinguish all or part of a financial liability at either the fair value of the equity instruments issued or the fair value of the liability extinguished.

A61 If only part of the financial liability issued in an arm's length transaction is extinguished by the issue of equity instruments, the enterprise also assesses the terms of the financial liability that remains outstanding to determine whether they are substantially different from those of the original financial liability. If the terms of the financial liability that remains outstanding are substantially different from those of the original financial liability, the ~~entity~~ enterprise accounts for the modification as the extinguishment of the original financial liability and the recognition of a new financial liability in accordance with paragraph 3856.26.

ILLUSTRATIVE EXAMPLES

This material is illustrative only.

These examples illustrate how the accounting treatment specified in this Section might be applied in particular situations. Matters of principle related to particular situations should be decided in the context of this Section.

Initial measurement of related party financial instruments

Example 1 – Initial measurement of related party loans

Example 2 – Initial measurement of common shares issued between related parties

Example 3 – Initial measurement of common shares and a note receivable issued between related parties in exchange for land and a trade receivable

INITIAL MEASUREMENT OF RELATED PARTY FINANCIAL INSTRUMENTS

Example 1 – Initial measurement of related party loans

Company A advances $100,000 cash to Company B, a related party, and receives as consideration a note receivable. The note has a face amount of $100,000 and does not have a maturity date or specified terms of repayment.

Entry by Company A

Dr. Note receivable	100,000	
Cr. Cash		100,000

To record loan to Company B.

Entry by Company B

Dr. Cash	100,000	
Cr. Note payable		100,000

To record loan from Company A.

A debt instrument with no stated repayment terms is deemed payable on demand. Therefore, both Company A and Company B initially measured the note at cost which was determined using the undiscounted cash flow(s), excluding interest and dividend payments, of the instrument.

Example 2 – Initial measurement of common shares issued between related parties

Company C received common shares in Company D, a related party, as consideration for land transferred from Company C to Company D. Companies C and D are under the common control of Company E. The carrying amount of the land in the accounts of Company C is $250,000 and the land's exchange amount is $300,000.

Entries by Company C

Situation I – Transaction measured at carrying amount of the land.			Situation II – Transaction measured at exchange amount of the land.		
Dr. Investment in CD	250,000		Dr. Investment in Co. D	300,000	
Cr. Land		250,000	Cr. Land		250,000
			Cr. Gain		50,000
To record the sale of the land.			To record the sale of the land. The gain on the sale is recognized in net income.		

In Situations I and II, the cost of the investment in Company D is initially measured at the carrying or exchange amount of the land transferred as consideration for the investment.

Example 3 – Initial measurement of common shares and a note receivable issued between related parties in exchange for land and a trade receivable

Company F transferred a trade receivable and land to Company G, a related party. As consideration for the transaction, Company F received common shares in Company G and a note receivable from Company G. The face amount of the trade receivable is $100,000. The carrying amount of the land in the accounts of Company F is $45,000 and the land's exchange amount is $65,000. The terms of the note receivable from Company G are:

- the face amount of the note is $120,000;
- the note is due in five years; and
- the interest rate on the note is seven percent.

Entries by Company F

Situation I – Transaction measured at carrying amount of the land.			Situation II – Transaction measured at exchange amount of the land.		
Dr. Investment in Co. G	25,000		Dr. Investment in Co. G	45,000	
Dr. Note receivable	120,000		Dr. Note receivable	120,000	
Cr. Land		45,000	Cr. Gain		20,000
Cr. Trade receivable		100,000	Cr. Land		45,000
			Cr. Trade receivable		100,000

To record the sale of the land and transfer of the trade receivable.	To record the sale of the land and transfer of the trade receivable.

In Situations I and II, the cost of the note receivable is determined using the undiscounted cash flows of the instrument, excluding interest and dividend payments. The cost of the investment in Company G is initially measured with reference to the consideration paid in the transaction, less the cost of the note receivable from Company G.

Entries by Company G

Situation I – Transaction measured at carrying amount of the land.			Situation II – Transaction measured at exchange amount of the land.		
Dr. Land	45,000		Dr. Land	65,000	
Dr. Trade receivable	100,000		Dr. Trade receivable	100,000	
Cr. Note payable		120,000	Cr. Note payable		120,000
Cr. Common shares		25,000	Cr. Common shares		45,000
To record the purchase of the land and transfer of the trade receivable.			To record the purchase of the land and transfer of the trade receivable.		

In Situations I and II, the cost of the note payable and trade receivable is determined using the undiscounted cash flows of the instrument, excluding interest and dividend payments. The cost of Company G's common shares is initially measured with reference to the consideration paid in the transaction, less the cost of the note payable by Company G.

CONSEQUENTIAL AMENDMENTS TO ACCOUNTING STANDARDS FOR PRIVATE ENTERPRISES IN PART II OF THE CPA CANADA HANDBOOK – ACCOUNTING

The following significant consequential amendments to Part II of the Handbook have been identified. Additional text is denoted by underlining and deleted text by strikethrough.

FIRST-TIME ADOPTION – Section 1500

RECOGNTION, MEASUREMENT AND PRESENTATION

Exemptions from other standards

Financial instruments

…

.21 At the date of transition to accounting standards for private enterprises, an ~~entity~~ enterprise is permitted to designate any financial asset or financial liability, issued in an arm's length transaction, to be measured at fair value in accordance with FINANCIAL INSTRUMENTS, paragraph 3856.13(a).

.21A A first-time adopter may apply the transitional provisions in FINANCIAL INSTRUMENTS, paragraphs 3856.63-.64 to financial instruments in related party transactions.

Related party transactions

.25 RELATED PARTY TRANSACTIONS, Section 3840, specifies that ~~certain~~ non-financial assets and non-financial liabilities (i.e. assets as liabilities that are excluded from the scope of FINANCIAL

INSTRUMENTS, Section 3856) in related party transactions shall be measured at the carrying amount and some at the exchange amount. An ~~entity~~ enterprise is not required to restate non-financial assets or non-financial liabilities related to transactions with related parties when the related party transaction occurred prior to the date of transition to accounting standards for private enterprises.

…

EFFECTIVE DATE AND TRANSITION

.38 Except as specified in paragraphs 1500.39-.42~~1~~, this Section applies to annual financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier application is permitted.

…

.42 Amendments to paragraphs 1500.21 and 1500.25 and new paragraph 1500.21A, issued in XXX 201X, applies to annual financial statements relating to fiscal years beginning on or after January 1, 2020. Earlier application is permitted.

RELATED PARTY TRANSACTIONS – Section 3840

PURPOSE AND SCOPE

…

.02 This Section does not apply to:

(a) ~~m~~Management compensation arrangements, including employee future benefits accounted for in accordance with EMPLOYEE FUTURE BENEFITS, Section 3462, expense allowances and other similar payments, including loans and receivables, to individuals, in the normal course of operations.~~; and~~

(b) T~~t~~ransactions between an enterprise preparing non-consolidated financial statements and subsidiaries:

(i) that are only controlled through means other than voting interests, potential voting interests, or a combination thereof, and

(ii) for which control is the only basis for the related party relationship.

Transactions with such enterprises are governed by other Sections, such as CONTRACTUAL OBLIGATIONS, Section 3280.

(c) T~~t~~he measurement or derecognition of a financial asset originated or acquired, or a financial liability issued or assumed in a related party transaction (see FINANCIAL INSTRUMENTS, Section 3856).

…

MEASUREMENT

…

.16 The carrying amounts of items involved in a related party transaction may differ from each other. For example, an enterprise transfers an investment portfolio measured in accordance with FINANCIAL INSTRUMENTS, Section 3856,~~carried~~ at $1,000, in its own records, to a related party, in exchange for property carried at $700 in the related party's records. The enterprise records the property received at $700 and the related party records the investment portfolio received in accordance with FINANCIAL INSTRUMENTS, Section 3856, at $1,000. The difference is accounted for in accordance with paragraph 3840.09

.17 When a related party transaction involving an exchange of non-financial items or a non-financial item for a financial instrument is measured at the carrying amount, any difference between the carrying amounts of the items exchanged, together with any tax amounts related to the item transferred, is a contribution of capital to, or a distribution of equity of, the enterprise. A net credit is a capital contribution and is credited to contributed surplus. A net debit is an equity distribution and is charged against any existing credit balance in contributed surplus arising from previous related party transactions, with any excess charged against retained earnings.

…

Transaction not in the normal course of operations

…

.37 An enterprise may enter into an arrangement to set up a wholly owned subsidiary and transfer assets to it in contemplation of the subsidiary issuing shares to unrelated parties either before or after the transfer. ~~Such a transfer is~~ A financial instrument, in such a transfer, is measured in accordance with FINANCIAL INSTRUMENTS, Section 3856, and non-financial items are measured at the carrying amount of the assets to the parent company, unless the criteria of COMPREHENSIVE REVALUATION OF ASSETS AND LIABILITIES, Section 1625, are met, since there was no substantive change in the ownership interests in the transferred assets at the time the transfer was arranged.

…

.44 Except as specified in SUBSIDIARIES, paragraph 1591.26A(a), a business transferred between two enterprises under common control is accounted for as follows:

(a) When the criteria in paragraph 3840.29 are met and the transaction is measured at the exchange amount, the business combination is accounted for in accordance with BUSINESS COMBINATIONS, Section 1582.

(b) When the criteria in paragraph 3840.29 are not met, the acquiring enterprise records the acquired non-financial assets and non-financial liabilities at their carrying amount in the balance sheet of the transferred business and, if appropriate, recognizes a non-controlling interest in accordance with NON-CONTROLLING INTERESTS, Section 1602. Any change in the non-controlling interest is recognized as an equity transaction in accordance with Section 1602. The financial statements of the combined enterprise reflect the earnings, assets and liabilities of the acquired enterprise for the entire period in which the transfer occurred and for all prior periods..

…

(paragraphs 3840.49-50 deleted)

~~Financial instruments~~

~~.49 *Except as provided in paragraph 3840.50, when a financial instrument, as defined in FINANCIAL INSTRUMENTS, paragraph 3856.05, is created or transferred in a related party transaction, the transaction shall be measured at the carrying amount, in accordance with paragraph 3840.09, or at the exchange amount, if the conditions in paragraphs 3840.18 or 3840.29 are met.*~~

~~.50 *A transaction between an entity and a person or an entity whose sole relationship with the entity is in the capacity of management, as defined in paragraph 3840.04(d), shall be accounted for in accordance with FINANCIAL INSTRUMENTS, Section 3856.*~~

EFFECTIVE DATE AND TRANSITION

.61 Except as specified in paragraphs 3840.62-.643, this Section applies to annual financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier application is permitted.

…

.64 Amendments to paragraphs 3840.02, 3840.16-.17, 3840.37 and 3840.44, issued in XXX 201X, apply to annual financial statements relating to fiscal years beginning on or after January 1, 2020. Earlier application is permitted.

ILLUSTRATIVE EXAMPLES

This material is illustrative only.

These examples illustrate how the accounting treatment specified in this Section might be applied in particular situations. Matters of principle relating to particular situations should be decided in the context of this Section.

Accounting for related party transactions

Example 1 — Accounting for a purchase and subsequent sale of a capital asset

Example 2 — Accounting for an exchange of capital assets

Tax aspects of related party transactions

Example 3 — Sale of building without a special tax election

Example 4 — Sale of building with a Section 85 rollover election

Application of the disclosure requirements

Example 5 — Transactions entered into in the normal course of operations with related parties

Example 6 — Transaction not in the normal course of operations involving a director (measured at the exchange amount)

Example 7 — Transaction not in the normal course of operations (measured at the carrying amount)

Measurement of financial assets and financial liabilities arising from related party transactions

~~Example 8 — Related party loans~~ (deleted)

~~Example 9 — Transfer of existing financial asset or financial liability~~ (deleted)

Example 10 — Transfer of existing financial asset or financial liability associated with transfer of non-monetary asset

Example 11 — Origination of financial asset or financial liability on transfer of non-monetary asset

Example 3 — Sale of building without a special tax election

Company A owns a building purchased from an unrelated party for $800. At the end of 20X1, the net book value of the building is $700 and the tax class containing the building has a balance of $2,000. At the end of 20X1, Company A sells the building to Company B, a related party. The consideration received comprises cash of $800 and newly issued shares of Company B with a value of $200. There is no balance in either the seller's or buyer's contributed surplus accounts resulting from previous related party transactions.

Each Company's tax rate is 40 percent. The transaction gives rise to a capital gain and the inclusion rate for taxable capital gains is 50~~75~~ percent.

For the purposes of this example, assume that Company A has control, joint control or significant influence over Company B.

Entries by Company A (Seller)

Transaction measured at exchange amount			Transaction measured at carrying amount		
Dr. Cash	800		Dr. Cash	800	
Dr. Investment in Co. B	200		Dr. Investment in Co. B	1	
Cr. Building		700	Cr. Building		700
Cr. Gain		300	Cr. Contributed surplus		101
To record sale of building. The gain on sale is recognized in income.			To record sale of building. The difference between the carrying amount of cash and shares received and the carrying amount of the building given up is credited to contributed surplus. (The carrying amount attributed to the shares of Company B is a nominal value of $1.)		
Dr. Future income tax expense	40		Dr. Contributed surplus	40	
Cr. Future income tax liability		40	Cr. Future income tax liability		40
To record future income taxes related to the sale of the building. The UCC pool has been credited with $100 [$800 – $700] more than has the NBV of the assets [$100 x .40].			To record future incomes taxes related to the sale of the building. The UCC pool has been credited with $100 [$800 – $700] more than has the NBV of the assets. The tax charge [$100 x .40] is debited to contributed surplus, being the same location as the difference in the first journal entry is recorded (in accordance with paragraph 3840.17).		
Dr. Current income tax expense	40~~60~~		Dr. Contributed surplus	40~~60~~	
Cr. Current income taxes payable		40~~60~~	Cr. Current income taxes payable		40~~60~~

To record current taxes on the taxable gain on sale [$200 x .50~~75~~ x .40].

To record current taxes on the taxable gain on sale [$200 x .50~~75~~ x .40]. The tax charge is debited to contributed surplus, being the same location as the difference in the first journal is recorded (in accordance with 3840.17).

Even though the accounting gain is zero, and the tax for accounting purposes is zero, a tax entry results. This is because, for tax purposes, the transaction is considered to be a sale from one legal ~~entity~~ enterprise to another. However, for accounting purposes, the difference is treated as a capital receipt. The enterprise has simply moved its asset to another account (i.e., another company).

Dr. Future income tax asset	40~~60~~	
Cr. Contributed surplus		40~~60~~

To record future income taxes related to the shares

A deductible temporary difference arises for the difference between the tax basis of the shares of $200 and the carrying amount of $1. If the investment in Company B represents an investment subject to significant influence ~~or a portfolio investment~~, a future income tax asset would be recognized.

Where the investment in Company B represents an investment in a subsidiary or an interest in a joint arrangement, no future income tax asset or liability is recognized when it is apparent that the temporary difference will not reverse in the foreseeable future (paragraph 3465.35).

Worksheet 1

	Accounting	Tax
Proceeds	$1,000	$1,000
Net book value/ACB	700	800

	Accounting	Tax
Proceeds	$ 700	$1,000
Net book value/ACB	700	800

Gain	300	200
Temporary difference	100	—
	200	200
	× 0.50~~75~~	× 0.50~~75~~
Taxable portion	10~~5~~0	10~~5~~0
Tax rate	× 0.40	× 0.40
	$ 640	$ 640

Gain	—	200
		× 0.50~~75~~
Taxable portion		100~~50~~
Tax rate		× 0.40
		$ ~~6~~40

The difference between the seller's accounting in each transaction is that in the transaction measured at the exchange amount the gain and resulting tax effects are accounted for in the income statement whereas in the transaction measured at the carrying amount the difference between the carrying amounts of the assets transferred, and the related transfer of tax amounts, are accounted for in equity. (Note that the equity entry is to contributed surplus since it is a net credit.)

Entries by Company B (Buyer)

Measured at exchange amount			Measured at carrying amount		
Dr. Building	1,000		Dr. Building	700	
Cr. Cash		800	Dr. Retained earnings	101	
Cr. Share capital		200	Cr. Cash		800
			Cr. Share capital		1
To record purchase of building.			To record purchase of building. The difference between the carrying amount of cash and shares given up and the carrying amount of the building received is debited to retained earnings.		

Worksheet 2

Calculations			Calculations		
UCC to buyer:			UCC to buyer:		
Seller's ACB		$800	Seller's ACB		$800
Plus capital gain:			Plus capital gain:		
Transfer price	$1,000		Transfer price	$1,000	
Seller's ACB	800		Seller's ACB	800	
	200			200	
	0.~~7~~50	10~~5~~0		0.~~7~~50	10~~5~~0
UCC (tax basis) to buyer		$90~~5~~0	UCC (tax basis) to buyer		$90~~5~~0

The difference between the transfer price of $1,000 and the tax basis of $90~~5~~0 is a taxable temporary difference. In accordance with paragraph 3465.41, the cost of future income taxes is added to the carrying amount of the asset. The cost of future income taxes is determined as $~~5~~100 (.40)/(1 – .40) = $67~~33~~.

The journal entry is:

Dr. Building	67~~33~~	
Cr. Future income tax liability		67~~33~~

To record future income taxes on purchase of building

The difference between the carrying amount of $700 and the tax basis of $90~~5~~0 is a deductible temporary difference. In accordance with paragraph 3465.59, since the difference between the carrying amount of the asset acquired and the exchange amount is charged to retained earnings, the future income tax benefit of $~~10~~80 ($20~~5~~0 .40) related to the transaction is credited to retained earnings.

The journal entry is:

Dr. Future income tax asset	~~10~~80	
Cr. Retained earnings		~~10~~80

To record future income taxes on purchase of building

The tax basis of the asset acquired is the same whether the transaction is measured at the exchange amount or at the carrying amount by the buyer since no special tax election has been claimed.

There are three differences between the accounting, by the buyer, in each of these transactions:

(i) In the transaction measured at the exchange amount, the carrying amount of the asset is increased. The income tax effects of the temporary difference between the transfer price and the tax basis is included in the carrying amount of the asset in accordance with paragraph 3465.41.

(ii) In the transaction measured at the carrying amount, the difference between the transferor's carrying amounts of the assets transferred is accounted for in equity in accordance with 3840.17. The net effect on equity is a decrease of $1, the book value of the shares issued by Company B.

(iii) Also, in the transaction measured at the carrying amount, the buyer has acquired a tax benefit that is recognized (provided there is sufficient assurance of recovery) in accordance with INCOME TAXES, Section 3465.

~~Example 8 — Related party loans~~

~~Company A advances $100,000 cash to related Company B. The terms of the loan imply a fair value of $103,000.~~

~~Company A~~
~~Non-consolidated Parent Company~~

~~Situation I — Transaction measured at carrying amount~~

~~Dr. Loan~~	~~100,000~~	
~~Cr. Cash~~		~~100,000~~

~~To record loan to Company B~~

~~Situation II — Transaction measured at exchange amount~~

~~Dr. Loan~~	~~100,000~~	
~~Cr. Cash~~		~~100,000~~

~~To record loan to Company B~~

~~Company B~~

~~Non-consolidated Subsidiary Company~~

~~Situation I — Transaction measured at carrying amount~~

~~Dr. Cash~~	~~100,000~~	
~~Cr. Loan~~		~~100,000~~
To record loan from Company A		

~~Situation II — Transaction measured at exchange amount~~

~~Dr. Cash~~	~~100,000~~	
~~Cr. Loan~~		~~100,000~~
To record loan from Company A		

~~Example 9 — Transfer of existing financial asset or financial liability~~

~~This example illustrates the accounting for a transfer between related parties of an interest-bearing financial asset. Company A owns 75 percent of Company B. Company A owns a bond with a fair value of $102,000 and amortized cost of $92,000. It transfers the bond to Company B for $95,000.~~

~~Company A~~
~~Non-consolidated Parent Company~~

~~Situation I — Transaction measured ?at carrying amount~~

~~Dr. Cash~~	~~95,000~~	
~~Cr. Bond~~		~~92,000~~
~~Cr. Contributed surplus~~		~~3,000~~
~~To record the sale of bond to Company B~~		

~~Situation II — Transaction measured at exchange amount~~

~~Dr. Cash~~	~~95,000~~	
~~Cr. Bond~~		~~92,000~~
~~Cr. Gain on sale of bond~~		~~3,000~~
~~To record the sale of bond to Company B~~		

~~Company B~~
~~Non-consolidated Subsidiary Company?~~

Situation I — Transaction measured at carrying amount

~~Dr. Bond~~	~~92,000~~	
~~Dr. Retained earnings~~		~~3,000~~
~~Cr. Cash~~		~~95,000~~
~~To record purchase of bond~~		

Situation II — Transaction measured at exchange amount

~~Dr. Cash~~	~~95,000~~	
~~Cr. Bond~~		~~92,000~~
~~Cr. Gain on sale of bond~~		~~3,000~~
~~To record purchase of bond~~		

~~In Situation I, the transfer is a carrying amount transaction in accordance with paragraphs 3840.08 and 3840.29. Situation II illustrates the entries for an exchange amount transaction in accordance with paragraph 3840.18.~~

Example 10 — Transfer of existing financial asset or financial liability associated with transfer of non-monetary asset

This example illustrates the initial measurement of an existing financial asset or financial liability transferred between related parties. Company A owns 75 percent of Company B. On January 1, 20X1, Company A transfers a building to Company B, together with the associated mortgage liability. The building's carrying amount in Company A's financial statements is $90,000. The mortgage loan's ~~carrying amount~~ cost is determined using undiscounted cash flows ~~in Company A's financial statements are~~ is $92,000. The agreed exchange amount is $95,000. ~~The fair value of a similar loan at market rates at the date of transfer is $102,000.~~ Neither company has any existing balance in contributed surplus resulting from previous related party transactions.

Company A
Non-consolidated Parent Company

Situation I — ~~Transaction~~ Non-financial asset measured at carrying amount			Situation II — ~~Transaction~~ Non-financial asset measured at exchange amount		
Dr. Mortgage loan	92,000		Dr. Mortgage loan	92,000	
Cr. Building		90,000	Cr. Building		90,000
Cr. Contributed surplus		2,000	Cr. Gain on sale of building		2,000
To remove building and mortgage loan			To remove building and mortgage loan		

In situations I and II, the building and mortgage loan are removed from Company A's books. In Situation I, the difference between the ~~carrying amount~~ cost of the loan determined using the undiscounted cash flows, excluding interest and dividend payments of the instrument (see FINANCIAL INSTRUMENTS, Section 3856) and the carrying amount of the building is considered to be a capital receipt by Company A from Company B. In Situation II, the difference is recognized as a gain in net income.

Company B
Non-consolidated Subsidiary Company

Situation I — ~~Transaction~~ Non-financial asset measured at carrying amount			Situation II — ~~Transaction~~ Non-financial asset measured at exchange amount		
Dr. Building	90,000		Dr. Building	95,000	
Dr. Retained earnings	2,000		Cr. Mortgage loan		95,000
Cr. Mortgage loan		92,000			
To recognize building and mortgage loan			To recognize building and mortgage loan		

In Situation I, the building and mortgage loan are recognized in Company B's books at ~~the predecessor carrying amount~~ the cost of the loan determined using undiscounted cash flows, excluding interest and dividend payments of the instrument (see FINANCIAL INSTRUMENTS, Section 3856). ~~The mortgage loan is not restated to fair value on initial recognition.~~ The difference between the ~~carrying amount~~ cost of the mortgage loan and the carrying amount of the building is considered to be a capital payment from Company B to Company A. In Situation II, Company B records both the building and mortgage loan at the exchange amount (supported by independent evidence)

Example 11 — Origination of financial asset or financial liability on transfer of non-monetary asset

Company A transfers land to Company B and takes back a loan in a carrying amount transaction. The carrying amount of the land is $90,000, its fair value is $105,000, the loan's face value is ~~for~~ $100,000 and the fair value of the loan is $99,000. Company B recorded a balance in contributed surplus of $4,000 prior to the transaction.

Company A
Non-consolidated Parent Company

Situation I — ~~Transaction~~ Non-financial asset measured at carrying amount			Situation II — ~~Transaction~~ Non-financial asset measured at exchange amount		
Dr. Loan	100,000		Dr. Loan	100,000	
Cr. Land		90,000	Cr. Land		90,000
Cr. Contributed surplus		10,000	Cr. Gain on sale of land		10,000
To record sale of land and recognize loan			To record sale of land and recognize loan		

In situations I and II, the land is removed from Company A's books and the loan receivable from

Company B is recognized. In Situation I, the difference between the cost of the loan determined using the ~~carrying amount~~ undiscounted cash flows, excluding interest and dividend payments of the instrument (see FINANCIAL INSTRUMENTS, Section 3856) and the carrying amount of the land is considered to be a capital receipt by Company A from Company B. In Situation II, the difference is recognized as a gain in net income.

Company B
Non-consolidated Subsidiary Company

Situation I — ~~Transaction~~ Non-financial asset measured at carrying amount			Situation II — ~~Transaction~~ Non-financial asset measured at exchange amount		
Dr. Land	90,000		Dr. Land	100,000	
Dr. Contributed surplus	4,000		Cr. Mortgage loan		100,000
Dr. Retained earnings	6,000				
Cr. Loan		100,000			
To recognize purchase of land and loan			To recognize purchase of land and loan		

In Situation I, the land is recognized in Company B's books at the predecessor carrying amount. The difference between the ~~carrying amount~~ cost of the loan determined using the undiscounted cash flows, excluding interest and dividend payments of the instrument (see FINANCIAL INSTRUMENTS, Section 3856) and the carrying amount of the land is considered to be a capital payment from Company B to Company A recorded first as a reduction of the existing balance in contributed surplus, then as a debit to retained earnings. In Situation II, Company B records both the land and loan at the exchange amount (supported by independent evidence).

CONSEQUENTIAL AMENDMENTS TO ACCOUNTING STANDARDS FOR NOT-FOR-PROFIT ORGANIZATIONS IN PART III OF THE CPA CANADA HANDBOOK – ACCOUNTING

The following significant consequential amendments to accounting standards for not-for-profit organizations have been identified. Additional text is denoted by underlining and deleted text by strikethrough.

FIRST-TIME ADOPTION BY NOT-FOR-PROFIT ORGANIZATIONS – Section 1501

RECOGNTION, MEASUREMENT AND PRESENTATION

Exemptions from other standards in Part II of the Handbook

Financial instruments

…

.21 At the date of transition to accounting standards for not-for-profit organizations, an organization is permitted to designate any financial asset or financial liability, issued in an arm's length transaction, to be measured at fair value in accordance with FINANCIAL INSTRUMENTS, paragraph 3856.13(a) in Part II of the Handbook.

.21A An organization may apply the transitional provisions in FINANCIAL INSTRUMENTS, paragraphs 3856.63 -.64 in Part II of the Handbook to financial instruments in related party transactions.

EFFECTIVE DATE AND TRANSITION

.35 Except as specified in paragraphs 1501.36-.37, this Section applies to annual financial statements relating to fiscal years beginning on or after January 1, 2012. Earlier application is permitted.

…

.37 New paragraph 1501.21A and amendments to paragraph 1501.21 apply to annual financial statements relating to fiscal years beginning on or after January 1, 2020. Earlier application is permitted.

SECTION 4460

DISCLOSURE OF RELATED PARTY TRANSACTIONS BY NOT-FOR-PROFIT ORGANIZATIONS

PURPOSE AND SCOPE

.01 This Section establishes disclosure standards for related party transactions in the financial statements of not-for-profit organizations. The measurement of related party transactions is not dealt with in this Section.

.01A Except as otherwise specified, a not-for profit organization applies FINANCIAL INSTRUMENTS, Section 3856 in Part II of the Handbook to the accounting for and disclosure of related party financial instruments.

EFFECTIVE DATE AND TRANSITION

.19 Except as specified in paragraph 4460.20, t~~T~~his Section applies to annual financial statements relating to fiscal years beginning on or after January 1, 2012. Earlier application is permitted.

.20 New paragraph 4460.01A applies to annual financial statements relating to fiscal years beginning on or after January 1, 2020. Earlier application is permitted.