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Caution: preferred shares changing

Canadian accounting rules for redeemable/retractable shares have changed

If your entity's financial statements have preferred shares included in equity, you may be affected by recent changes to accounting standards.

What is the issue?

A common method of passing on a business or assets to a buyer or the next generation is to 'freeze' the value accumulated to a point in time in a special class of shares, and then provide future value generation through another class of shares, typically common shares. These types of transactions often involve the issuance of a special class of shares that are either:

(a) Retractable by the holder/owner of those shares. This means they can require the issuing company to repurchase them.

(b) Mandatorily redeemable by the issuing company. This means the terms of the shares require the company to repurchase them from the holder/owner at some point in the future.

These special shares are called RoMRS (retractable or mandatorily redeemable shares). Under Canadian accounting standards for private enterprises (ASPE), RoMRS meet the definition of a liability at their full redemption amount. ASPE Section 3856, on financial instruments, currently includes an exemption to the liability classification if the RoMRS are issued under certain tax planning arrangements according to the Canadian Income Tax Act. This exemption allows these RoMRS to be classified as equity at their stated or issued amount.

Effective January 1, 2021, the exemptions are changing! The exception to liability classification for RoMRS under ASPE Section 3856 was amended to require an assessment of the individual facts and circumstances surrounding the terms and conditions under which the RoMRS were issued, eliminating the references to the Income Tax Act. As a result of this amendment, many entities may have to show RoMRS as a liability at their full redemption amount on their financial statements, rather than including them as equity at their stated or issued amount.

Why does it matter?

With the classification change from equity to liability and the measurement change from stated or issued amount to the full redemption amount, RoMRS that fail the new equity classification exemptions will result in a significant increase in liabilities and a significant decrease in equity on the balance sheet starting on January 1, 2021.

What are the implications?

- A significant increase in current liabilities will negatively impact any performance measures or ratios that include liabilities (e.g. working capital amounts or ratios such as debt-to-equity or current ratios). Measures or ratios involving equity will also be affected, such as ratios of assets or operations to equity. A debt-to-equity ratio will be further affected by the concurrent decrease in equity. Companies will need to revisit

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their banking, employment, and other agreements to determine how the revised presentation will affect things like compliance, management or employee performance measures, and potential payouts on various agreements.

- Any dividend declared on RoMRS that are classified as liabilities will be recognized as an expense in the income statement, as opposed to a distribution directly from equity, which reduces the net income. Metrics and profitability reported in the financial statements will also be affected. Companies will need to review any agreements as well as management and operational reporting to determine the impact.
- As previously described, the liability classification of RoMRS will reduce equity and earnings on financial statements. This amendment could have adverse effects for shareholders who want to sell their ownership interest or obtain financing in the near future, as the significant current liability on the balance sheet may appear unattractive to potential buyers or lenders at first glance.

It is important to plan for and proactively manage this upcoming amendment on a timely basis.

What should you do next?

If an assessment of the classification of RoMRS results in a change in their treatment from equity to liability, companies have an opportunity to avoid such a change appearing on financial statements when the rules become effective by revising, replacing, or eliminating the RoMRS. However, this must be done prior to January 1, 2021 to avoid any appearances in upcoming financial statements.

In many situations, RoMRS were issued as part of tax planning arrangements (such as an estate freeze) or certain types of transactions (such as transfer of business to the next generation), and are typically structured based on the specific needs and circumstances of the shareholders at the time. Any attempts to deal with the future treatment of RoMRS under the new standards will require a detailed analysis of the RoMRS themselves, as well as any associated tax implications of contemplated changes. Changes must be agreeable to all shareholders involved — which could take time.

A tailored solution is required for each situation. To be most effective, companies must take action as soon as possible.

BDO is here to help. We have the people, tools, and knowledge to help you through these changes. Please contact your local BDO partner/advisor to start the conversation.

Action Checklist

- [ ] Reach out to BDO to gather more information and arrange for an assessment.
- [ ] Work with BDO to analyze your scenario to determine the implications of the revised standards.
- [ ] Where changes are anticipated, consider the options available for revisions to the capital structure and/or affected parties of the company.
- [ ] Consider other capital planning strategies that might also respond to the upcoming revisions.
- [ ] Inform affected parties of the changes that they will see in the financial statements.

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