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ASSURANCE AND ACCOUNTING

A GUIDE TO FINANCIAL INSTRUMENTS FOR PRIVATE ENTERPRISES AND PRIVATE SECTOR NOT-FOR-PROFIT ORGANIZATIONS

For many entities adopting the Accounting Standards for Private Enterprises (ASPE), the accounting for Financial Instruments will be one of the most significant changes in their financial statements. Understanding the accounting for financial instruments is critical for all entities, as even the simplest entities have financial instruments.

All of the accounting requirements related to financial instruments are contained in Section 3856, Financial Instruments of Part II of the CICA Handbook - Accounting[1] . Under pre-changeover GAAP, the accounting for financial instruments was covered by a series of standards, accounting guidelines and EICs; ASPE has simplified this by grouping the majority of accounting requirements for financial instruments under one standard. This publication will cover all aspects of Section 3856 other than Hedge Accounting. For guidance on hedge accounting, see our publication A Guide to Hedge Accounting for Private Enterprises .

Scope

A financial instrument is defined as a contract that creates a financial asset for one entity and a financial liability or equity instrument of another entity. To understand this definition we must also define a financial asset, financial liability and equity instrument. They are defined as follows:

- A **financial asset** is any asset that is cash; a contractual right to receive cash or another financial asset from another party; a contractual right to exchange financial instruments with another party under conditions that are potentially favourable; or an equity instrument of another entity;
- A **financial liability** is any liability that is a contractual obligation; to deliver cash or another financial asset to another party; or to exchange financial instruments with another party under conditions that are potentially unfavourable to the entity; and
- An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Common examples of financial instruments include:

- Cash;
- Demand and fixed-term deposits;
- Commercial paper, bankers' acceptances, treasury notes and bills;
- Accounts, notes and loans receivable and payable;
- Bonds and similar debt instruments, both issued and held as investments;

1. This publication is also applicable to Not-for-Profit organizations adopting Part III of the CICA Accounting Handbook. They are also required to follow Section 3856 from Part II of the Handbook.

- Common and preferred shares and similar equity instruments, both issued and held as investments; and
- Options, warrants, futures contracts, forward contracts, and swaps.

In general, Section 3856 applies to all financial instruments; however, there are some financial instruments which are excluded from the scope of the standard. Most of these exclusions relate to instruments which meet the definition of a financial instrument; however, the accounting for these items is determined by another standard (for example, lease accounting)[2] .

Contracts to buy or sell non-financial items other than exchange traded futures contracts and contracts that are designated in a qualifying hedging relationship are an important scope exclusion. These contracts do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation to receive, deliver or exchange a financial asset.

Recognition and Measurement

Initial Measurement

Upon initial recognition, all financial instruments originating in an arm's length transaction are to be measured at fair value. In most cases, this amount will be the amount of consideration paid or received, as fair value is defined as a price agreed upon by a willing buyer or seller in an arm's length transaction. In situations where there is a difference between the consideration paid or received and the fair value of the instrument, the difference should be recognized immediately in net income unless it qualifies as some other type of asset or liability. For example, when an entity receives an interest-free loan from a government agency, in the absence of evidence to the contrary, the difference between the fair value of the loan and the cash received is accounted for as a government grant. Similarly, when an entity extends an interest-free loan to an employee, in the absence of evidence to the contrary, the difference between the fair value of the loan and the cash paid to the employee is accounted for as employee compensation.

In the case of financial instruments that originate as a result of a related party transaction, initial measurement will be at exchange amount or carrying value in accordance with Section 3840, Related Party Transactions, rather than fair value. If the sole relationship is in the capacity of management, the parties involved are deemed to be unrelated for purposes of Section 3856 and as such, transactions will be initially measured at fair value.

At the time of initial measurement, transaction costs must also be considered. For instruments that are subsequently measured (see below) at cost or amortized cost, the amount initially recognized will be adjusted for transaction costs directly attributable to the instruments origination, acquisition, issuance or assumption. Otherwise transaction costs shall be recognized in net income as incurred.

Subsequent Measurement

The measurement of financial instruments subsequent to initial recognition will depend on the type of instrument as well as accounting policy choices made by the entity. The following instruments are required to be measured at fair value[3] with changes in fair value recognized in net income:

- Investments in equity instruments that are quoted in an active market[4]; and
- Derivative contracts other than those designated in a qualifying hedging relationship or derivatives that are linked to and must be settled by delivery of equity instruments of another entity whose fair value cannot be readily determined (eg. an option of shares of a private company).

All other financial assets are measured at cost or amortized cost less impairment and financial liabilities are measured at amortized cost. An entity may elect to measure any instrument at fair value by irrevocably designating that financial instrument when it is initially recognized or when an equity instrument ceases to be quoted in an active market. An entity that has an investment portfolio made up of stocks and bonds, both which are quoted in active market, may be an example of where this election is used for the bonds to ensure that both types of financial instruments are measured on the same basis.

When determining amortized cost either the effective interest rate or straight line methods may be used to recognize the premium or discount and all related transactions costs over the expected life of the instrument. The only exception to this amortized cost calculation is the treatment of a financial liability that is indexed to a measure of the entity's financial performance or to changes in the entity's equity. The liability is measured at the higher of the amortized cost of the debt and the amount that would be due at the balance sheet date if the formula for determining the additional amount was applied at that date. Any adjustment from amortized cost is recognized in net income as a separate component of net income.

Impairment

Impairment only needs to be considered for financial assets measured at cost or amortized cost. Financial assets measured at fair value do not need to be considered because any changes in fair value are recognized in net income. When considering impairment, individually significant assets should be assessed individually and other assets should be grouped on the basis of similar risk characteristics.

2. For a complete list of scope exclusions see paragraphs 3 and 4 of Section 3856.
3. The appropriate quoted fair value is as follows: equity instrument - usually the latest closing price, non-option derivative - usually mid-market prices or rates, options - usually bid prices for purchased options and ask prices for issued options, but mid prices may be used.
4. A financial instrument is regarded as quoted in an active market when quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices reflect actual and regularly occurring market transactions on an arm's length basis.

The most common example of grouping instruments relates to accounts receivable. The following specific guidance is provided in the standard:

> *When a group of financial assets, such as accounts receivable, is comprised of large numbers of homogeneous balances of relatively small dollar amounts, impaired assets within the group are commonly identified based upon delays in receipt of payment. The extent of impairment present in the group is estimated by applying formulae that take into account the analysis of arrears, aging of balances, past loss experience, current economic conditions and other relevant circumstances such as uncompensated payment delays. To ensure that the loss ratios applied reflect the most current information available, it is necessary that the formulae be reviewed regularly.*

The impairment model is indicator based; therefore, an entity must consider if there are any indicators of impairment. An indicator of impairment is a condition or event that will cause a significant adverse change in the expected timing or amount of future cash flows. Indicators of impairment include, but are not limited to the following:

- Significant financial difficulty of the customer or issuer;
- Default or delinquency in interest or principal payments;
- Granting concessions to the customer or issuer;
- Becoming probable that the customer will enter bankruptcy or other financial reorganization;
- Disappearance of an active market for the asset because of financial difficulties;
- Significant adverse change in technological, market, economic or legal environment which a customer or issuer operates; and/or
- Adverse national or local economic conditions or adverse change in industry conditions.

Events or conditions which are not necessarily indicators of impairment include:

- An active market disappearing is not an indicator, unless it's because of financial difficulties;
- A downgrade of credit rating by itself is not an indicator; and
- A decline in fair value below amortized cost. For example, a decline of fair value of a debt instrument may be caused by an increase in the risk free interest rate, which has no bearing on the timing and amount of future cash flows.

If an indicator is identified, an impairment loss will be recorded through net income to reduce the financial asset to the higher of:

- The present value of the expected cash flows from holding the asset discounted using the current market rate of interest;
- The amount that could be realized by selling the asset at the balance sheet date; or
- The net amount expected to be realized by exercising the right to any collateral.

Any impairment that is recorded can be recorded directly to the asset or using an allowance account. The impairment can also be reversed through net income if the situation changes.

Presentation

Liability vs. Equity

Like pre-changeover GAAP, Section 3856 requires an issuer of a financial instrument to classify the instrument, or its component parts, as a liability or equity in accordance with the substance of the contractual arrangement on initial recognition. The substance of the instrument may not always match its legal form.

The critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation to deliver cash or another financial asset to the other party or to exchange another financial instrument with the holder under conditions that are potentially unfavourable to the issuer. If the obligation can be settled through the issuance of shares, it would still be considered a liability when the number of an entity's own shares or other equity instruments required to settle the obligation varies with changes in their fair value, so that the total fair value of the equity instruments to be delivered is based solely or predominantly on the amount of the contractual obligation.

The standard contains exceptions from the principle of reflecting instruments in accordance with their substance. These exceptions are:

a) Preferred shares issued in a tax planning arrangement under Sections 51, 85, 85.1, 86, 87 or 88 of the Income Tax Act. The entity must present the shares at par, stated or assigned value as a separate line item in the equity section of the balance sheet, with a suitable description indicating that they are redeemable at the option of the holder. When redemption is demanded, the issuer reclassifies the shares as liabilities and measures them at the redemption amount. Any adjustment is recognized in retained earnings;

b) Partnership interests and certain types of shares in co-operative organizations that provide for payments to the holder of a pro rata share of the residual equity of the issuer. These financial instruments may require redemption in specified circumstances that are certain to arise, such as the death of the holder, but do not impose an obligation on the issuer to deliver or exchange any specific amount of financial assets in advance of redemption. On issuance, and subject to (c) below, such financial instruments constitute an equity instrument of the issuer. When the holder subsequently chooses to withdraw its equity and is entitled to do so, the issuer may become obliged to make a payment that is fixed or determinable as to amount and timing. This obligation satisfies the definition of a financial liability and is presented as such;

c) A retractable or mandatorily redeemable share, other than a share to which (a) above applies, is classified as a liability unless all of the following criteria are met:

- The redeemable shares are the most subordinated of all equity instruments issued by the enterprise;
- The redemption feature is extended to 100 percent of the shares and the basis for determination of the redemption price is the same for all shares;
- The shares have no preferential rights relative to other classes of shares of the enterprise that have the same degree of subordination; and
- The redemption event is the same for all the shares subject to the redemption feature.

Appendix A provides a decision tree to assist in the determination of whether an instrument is a liability or equity.

If an instrument has both liability and equity components, such as the case with convertible debt or when warrants or options are issued with and detachable from a liability, an accounting policy choice exists as there are two acceptable methods for measurement of the liability and equity elements on initial measurement:

- The equity component is measured at zero. As a result, the entire proceeds are allocated to the liability component; and
- The less easily measureable 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.

Interest, Dividends, Losses and Gains

The classification of an instrument in the balance sheet determines whether interest, dividends, losses and gains relating to that instrument are classified as expenses or income and reported in the income statement or as a charge to equity. Dividend payments on shares classified as liabilities are classified as expenses in the same way as interest on a bond is reported in net income. Similarly, gains and losses associated with redemptions or refinancing of instruments classified as liabilities are reported in net income, while redemptions or refinancing of instruments classified as equity are reported as changes in equity. Dividends classified as an expense may be presented in the income statement either with interest on other liabilities or as a separate item.

Offsetting

The requirements for offsetting are unchanged from pre-changeover GAAP. A financial asset and liability shall be offset and presented net, only when the entity meets the following conditions:

- The entity currently has a legally enforceable right to set off the recognized amounts; and
- The entity intends to either settle on a net basis, or to recognize the asset or realize the asset and settle the liability simultaneously.

Derecognition

The requirements related to derecognition of financial instruments are unchanged from pre-changeover GAAP.

In the case of transfers of receivables, an entity only derecognizes receivables transferred to another entity when control has been surrendered. The guidance to determine if control has been surrendered remains complex and entities should continue to consult with their BDO advisors on the accounting for transactions involving the sale or factoring of receivables. The criteria outlined in Appendix B of Section 3856 will determine whether the transaction should be treated as a sale or secured borrowings.

Financial liabilities are removed from the balance sheet when extinguished. A liability is considered extinguished when the debtor discharges the liability by paying the creditor or when the debtor is legally released from primary responsibility for the liability either by process of law or by the creditor. As a result, payments to third parties, including a trust (i.e. in-substance defeasance), by itself will not result in derecognition of the liability, without legal release from the creditor.

With regards to financial liabilities we must also consider whether modification of the terms of the instrument results in the extinguishment of the original instrument and recognition of new instrument or is just a modification. Extinguishment accounting will be applied when the change in terms is substantial. The change is considered substantial when:

- The present value of the cash flows under the new terms differs by at least 10% from the present value of the remaining cash flows under the original terms, both discounted at the original rate of interest; or
- There is a change in creditor or the original debt is legally discharged by the debtor through a cash payment or otherwise.

When a financial liability is derecognized the difference between the carrying amount of the liability extinguished and the fair value of the consideration paid is recognized in net income. In the case of a modification that results in extinguishment, the difference between the fair value of the new debt instrument and the carrying amount of the original instrument is recognized in net income.

Disclosure

Many entities moving to ASPE were still applying Section 3860, Financial Instruments: Presentation and Disclosure, under pre-changeover GAAP. The adoption of ASPE for these entities will result in an increase in financial instrument disclosures; however, the requirements are significantly less than what is required by International Financial Reporting Standards. Some of the increase in disclosures is due to the recognition and measurement requirements, which did not exist for entities previously applying Section 3860, and is required to explain the accounting policies and to explain the terms of amounts reflected in the financial statements.

The overall disclosure requirement of the standard is to enable users of the financial statements to evaluate the significance of financial

instruments to the entity's financial position and performance. This includes disclosure of the entities exposure to risk, how risk arises and changes in risk exposure for the previous year for credit, currency, interest rate, liquidity and other price risk. Included in these risk disclosures would be a description of any concentrations of risk. Concentrations of risk may arise from industry sectors, geographic distributions, credit qualities and a limited number of counterparties.

First-Time Adoption

Section 1500, First-Time Adoption, will be very important as entities transition from pre-changeover GAAP to ASPE[5] . Although Section 1500 generally requires retrospective adoption of ASPE, it does provide exceptions and exemptions from retrospective application. The following exemptions are provided for the accounting for financial instruments:

- Any difference between the recognition and measurement of financial instruments at the opening balance sheet date, in accordance with Section 3856, and the prior year's closing balance sheet is recorded as an adjustment to opening retained earnings at the date of transition to accounting standards for private enterprises;
- A First-Time adopter need not separate the liability and equity components of a compound financial instrument if the liability component is no longer outstanding at the date of transition to accounting standards for private enterprises; and
- At the date of transition an entity is permitted to designate any financial asset or financial liability to be measured at fair value.

Conclusion

On the adoption of ASPE, the adoption of Section 3856 will be a significant change for most entities. Talk to your BDO advisor to understand the impact it will have on you.

5. For NPOs, the Section is 1501, First-Time Adoption under Part III of the CICA Handbook - Accounting.

The information in this publication is current as of June 23rd, 2011.

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APPENDIX A

Equity vs. Liability Decision Tree