Accounting for Financial Instruments

AUGUST 2024

Accounting Standards For Private Enterprises (ASPE)

Update to Chapter 45

Introduction

Chapter 45 was last updated in August 2019. To supplement the Chapter, all revisions to the *CPA Canada Handbook – Accounting* that would affect Chapter 45 were reviewed. This Update includes:

- **summary of Handbook releases** issued from June 2019 to May 2024 (Release no. II.19 to II.33)
- **notes on application questions** discussed by the Accounting Standards Board's (AcSB) Private Enterprise Advisory Committee[1]
- **overview of risk disclosures and additional application examples**
- **additional application resources** available

The last update to Chapter 45 included the revisions for the "December 2018 amendments" to Section 3856, *Financial Instruments* (Release no. II.18) that:

- revised the classification requirements for Retractable or Mandatorily Redeemable Shares (ROMRS) issued in a tax planning arrangement
- clarified the accounting for related party financial instruments and resulted in a single standard that provides guidance on the accounting for financial instruments arising from transactions between both arms-length and related parties

1 Beginning in February 2024, application issues that meet the criteria for the **guidance framework** would have the notes included in the AcSB decision summary and are no longer being updated on the Private Enterprise Advisory Committee page.

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- required enterprises to disclose enterprise-specific information about significant risks arising from financial instruments

Chapter 45 also includes updates resulting from amendments to Section 4460, *Disclosure of Related Party Transactions by Not-for-Profit Organizations* issued in 2018. The amendments required not-for-profit organizations to apply Section 3856, *Financial Instruments* to the accounting for and disclosure of financial instruments in a related party transaction.

Summary of *Handbook* releases

The table below summarizes the amendments to Section 3856 from June 2019 to May 2024 and should be read with Chapter 45. Section 3856 and other *Handbook* Sections can be accessed through **Knotia**, which includes all revisions.

HANDBOOK RELEASE SUMMARY	COMMENTARY	PARAGRAPH REFERENCES TO CHAPTER 45 (STANDARD)
Release no. II.23 (April 2020) **Section 3856, *Financial Instruments*** A correction has been made to FINANCIAL INSTRUMENTS, paragraph 3856.68(b). The correction is to better reflect the AcSB's intent that an enterprise is not required to retrospectively apply the amendments specified in that paragraph to financial instruments that do not exist on the date the amendments are first applied.	The December 2018 amendments were generally to be applied retrospectively. However, transition paragraph 3856.68(b) was amended to clarify the relief provided. That is, an enterprise need not restate related party financial instruments at the beginning of the earliest comparative period for instruments that do not exist at the date the amendments are applied for the first time.	In paragraph 45-256, the extract of paragraph 3856.68(b) is out of date. (Paragraph 3856.68(b))
Release no. II.24 (August 2020) The **effective dates** of the following new or amended standards have been deferred as follows: Amendments to FINANCIAL INSTRUMENTS, Section 3856 (the December 2018 amendments), and DISCLOSURE OF RELATED PARTY TRANSACTIONS BY NOT-FOR-PROFIT ORGANIZATIONS, Section 4460, (See Highlight Summary No. II.18), issued in December 2018 are now effective for annual financial statements relating to fiscal years beginning on or after January 1, 2021.	The December 2018 amendments are reflected in Chapter 45, but with the January 1, 2020 effective date. As a result of the COVID-19 health pandemic, the AcSB deferred the effective date of the amendments by one year to be effective for years beginning on or after January 1, 2021.	Effective dates in paragraphs 45-256, 45-257 and 45-261 are out of date. (Paragraphs 3856.62 to 3856.68 and 4460.20)

HANDBOOK RELEASE SUMMARY	COMMENTARY	PARAGRAPH REFERENCES TO CHAPTER 45 (STANDARD)
Release no. II.26 (April 2021) **FINANCIAL INSTRUMENTS, Section 3856**, Illustrative Example 3, has been amended to use an assigned value of $45,000.	This amendment changed the entries for enterprise G (buyer) both when the transaction is measured at the carrying amount and exchange amount of the land in Situation I and Situation II, respectively. The entries for the transaction for enterprise F (seller) did not change.	Reference only to the example in paragraph 45-260. (Illustrative Example 3 in Section 3856)
Release no. II.29 (February 2022) **Section 3856, *Financial Instruments*** This Section has been amended to provide relief to debt modification accounting and hedge accounting during the reform of benchmark interest rates (IBOR reform[2]). Specifically, the amendments: (a) provide an optional expedient to account for debt modifications that are related to IBOR reform as a continuation of the existing contract and not as an extinguishment; and (b) require qualifying hedging relationships to continue upon a change in certain critical terms related to IBOR reform. These amendments are effective for fiscal years ending on or after February 1, 2022. Earlier application is permitted, including in financial statements not yet authorized for issue.	This relief was provided in response to a one-time reform in the external marketplace when IBORs in financial instruments were replaced with alternative benchmark rates. The use of an IBOR reference is not common in small business lending or hedging agreements. Due to the IBOR reform, an enterprise needs to assess if a lending agreement is considered modified, or if a hedging arrangement ended. This amendment provides relief to: (a) simplify the current accounting analysis for debt modifications solely due to IBOR reform; and (b) allow hedging relationships to continue when all changes made are directly related to IBOR reform. If applicable, the following disclosure requirement was added: **3856.54A** *An enterprise shall disclose the nature and the carrying amount of the financial instruments, and the notional amount of any derivatives, that are subject to IBOR reform.*	Not addressed in Chapter 45. The reference to "IBOR" in the application example in paragraph 45-216 could be replaced with "prime." (Section 3856, paragraphs 3856.27, 3856.35, 3856.29A-.29D, 3856.36A-.36E, 3856.54A, 3856.A54A -.54B and 3856.69-.71)

2 IBOR reform refers to the market-wide reform to replace interbank offered rates (IBORs), including but not limited to the Canadian dollar offered rate (CDOR) and the London interbank offered rate (LIBOR), with alternative benchmark rates. Section 3856.29B.

HANDBOOK RELEASE SUMMARY	COMMENTARY	PARAGRAPH REFERENCES TO CHAPTER 45 (STANDARD)
Release no. II.32 (September 2023) **Section 3856, *Financial Instruments*** This Section has been amended to clarify the initial measurement of financial instruments acquired or liabilities assumed when a business is transferred between two enterprises under common control. These amendments are effective for fiscal years beginning on or after **January 1, 2025**. Earlier application is permitted.	This amendment was made to clarify that Section 3856 does not apply to the **initial measurement** of financial assets acquired or financial liabilities assumed in a transaction when a business is transferred between two enterprises under common control. The guidance on how to initially measure such a financial asset/ financial liability is set out in Section 3840, *Related Party Transactions*. Section 3840 was amended to: • clarify the application of Section 1582, *Business Combinations* to initially account for business combinations under common control in accordance with paragraph 3840.44(a) • provide an option in paragraph 3840.44(b) to retrospectively restate prior periods when carrying amounts are used to account for a combination or to prospectively account for these transactions Section 3856 was also amended to require financial instruments assumed when a business is transferred between two enterprises under common control to be **subsequently measured** based on the initial measurement of the financial instrument in the transferred business.	Not addressed in Chapter 45. Several paragraphs in Chapter 45 are out of date, such as the paragraphs on the exception and subsequent measurement guidance in paragraphs 45-2 or 45-88, respectively. (Paragraphs 3856.04(c), 3856.11, 3840.44 and 3856.72)
Release no. II.33 (November 2023) Corrections have been made to the following paragraph in the *Handbook*: • FINANCIAL INSTRUMENTS, paragraph 3856.08	This amendment added a reference to paragraph 3856.04(c) to scope out financial assets and financial liabilities transferred between two enterprises under common control. Initial measurement of such a transaction is addressed in Section 3840. (See the release above.)	In paragraph 45-2, the extract of paragraph 3856.04 does not include the exception on initial measurement. (Paragraph 3856.08)

Remember that the overview of the key requirements of Section 3856 in Chapter 45 at paragraph 45-5 is out of date for the revisions discussed in this Update.

Notes on application questions

The Private Enterprise Advisory Committee (the Committee) assists and advises the AcSB in maintaining and improving accounting standards for private enterprises. The Committee discusses application questions received and summaries of their discussions are made available in meeting notes (See the **additional application resources**). The Committee's meeting notes are not authoritative.

Chapter 45 does not include references to the Committee's discussions. This Update includes a summary of application questions on ROMRS and Related Party Financial Instruments based on a review of the Committee's meeting notes from June 2019 to May 2024.

Retractable or Mandatorily Redeemable Shares (ROMRS)

The "December 2018 amendments" related to ROMRS had an effective date of January 1, 2021. Extracts from the Committee's meeting notes are included below:

MEETING DATE	SCENARIO	COMMITTEE DISCUSSION
November 10, 2022	One individual owns 100 per cent of the shares, including preferred shares that are ROMRS, of an operating enterprise. The individual sells 100 per cent of their shares, including ROMRS, to another unrelated party. Before the sale, the ROMRS were presented as equity because the criteria in *Financial Instruments*, paragraph 3856.23, were met. The Committee discussed whether the sale would require reclassification of the preferred shares to liabilities.	The Committee thought that because control is not retained, the criteria in paragraph 3856.23 would not be met, and the preferred shares would be reclassified to liabilities after the change of control.
October 27, 2021	The first two scenarios discussed involved preferred shares, mandatorily redeemable by the enterprise upon the holder's death. These scenarios included life insurance policies whose proceeds factored into the redemption amount of the preferred shares. 1. The Committee considered whether the preferred shares were within the scope of paragraph 3856.23. 2. The Committee also discussed whether the preferred shares should be classified as equity or a liability; and if the shares are a liability, what guidance should be applied to determine the redemption amount.	1. The Committee thought that sufficient guidance existed in the standard to determine that the tax planning arrangement was within the scope of paragraph 3856.23. 2. The Committee thought sufficient guidance existed in Section 3856 to determine whether the shares are equity or a liability. If the shares are a liability, members noted that judgment needs to be applied when measuring the liability and standards other than Section 3856 should be considered. The Committee thought sufficient guidance existed in Section 3856 and in other standards and, therefore, did not recommend standard setting.

MEETING DATE	SCENARIO	COMMITTEE DISCUSSION
October 27, 2021	The Committee discussed another scenario involving mandatorily redeemable preferred shares issued in a tax planning arrangement where indirect ownership or indirect control of the enterprise issuing the shares exists. The Committee discussed applying paragraph 3856.23(a), which requires control be retained by the shareholder receiving the shares in the arrangement.	The Committee noted the guidance refers to Section 1591, *Subsidiaries*, where details are available on assessing control. The Committee observed that the AcSB's podcast series and webinar were helpful in applying judgment to these scenarios and recommended the board issue a communication directing stakeholders to these resources. (The links to the podcast and webinar are included in the additional application resources section of this Update.)

Related party financial instruments

The "December 2018 amendments" on Related Party Financial Instruments also had an effective date of January 1, 2021. An extract from the Committee's meeting notes is included below:

MEETING DATE	SCENARIO	COMMITTEE DISCUSSION
November 18, 2021	The scenario discussed involved a related party transaction where a bond investment and an investment in equity instruments (not quoted in an active market) is exchanged for cash. Paragraph 3856.A8C provides guidance in measuring a related party transaction involving the exchange of multiple assets and liabilities and requires measurement of an instrument without repayment terms at the residual of the total consideration transferred in the transaction less the amounts attributed to the other assets or liabilities recognized in the transaction. In applying this guidance to the scenario provided, the investment in equity instruments is measured at the residual, resulting in an amount greater than its fair value.	Committee members agreed with the application of paragraph 3856.A8C in this scenario and noted that if the investment in equity instruments is not recoverable, then they should recognize an impairment.

Overview of risk disclosures and additional application examples

Application examples are included in this Update on the disclosure of significant risks and concentration of credit risk. A discussion on the application of professional judgment and how to assess financial risks including those that may be related to other disclosures is set out next.

The use of professional judgment is required in the preparation of these disclosures. Examples of areas when professional judgment is needed include the assessments of matters such as:

- what constitutes a significant risk
- when a concentration of financial risk exists
- when economic dependence disclosure is required (Section 3841, *Economic dependence*)
- when the going concern assumption may not be appropriate
- whether the disclosures faithfully represent the underlying significant risks and operations

What is a significant risk?

When exercising professional judgement related to the assessment of whether a risk is significant or not, the following factors can be considered:

- size and nature of the risk
- susceptibility to misstatement of the underlying financial asset or liability that creates the risk with particular attention to those financial instruments measured at fair value
- the volatility of the risk exposure
- other factors

Has the risk changed from the previous period?

When exercising professional judgment to assess whether a risk has changed from the previous period, the following factors can be considered:

INTERNAL FACTORS	EXTERNAL FACTORS
• changes in operational activities that change the size and nature of financial instruments that have significant risks • a new operational activity • an unusual activity • other factors	• interest rate changes • foreign exchange rate fluctuation, if applicable • inflation rates • economic outlook • other factors

The following format may be useful to identify the information to disclose:

TYPES OF RISKS	SIGNIFICANT RISK? (Y/N)	CHANGE IN RISK FROM PREVIOUS PERIOD? (Y/N)	CONCENTRATION OF RISK? (Y/N)	RATIONALE AND SUPPORT
Credit risk				
Liquidity risk				
Market risk – interest rate risk				
Market risk – foreign currency risk				
Market risk – other price risk				

Completing this table would also help document the professional judgement applied. The documentation would include an explanation of the rationale to support each Y/N answer.

The wording of the note disclosure must be drafted to be specific to the enterprise and not use “boilerplate” wording that would not be as useful to the readers of the financial statements.

Disclosure: Significant risks

As set out in Chapter 45, paragraphs 45-250 to 45-253, **paragraphs 3856.53** and **53A** require disclosure of each significant risk arising from financial instruments. The following Application Example illustrates the following scenario:

The enterprise has simple financial assets and financial instruments and has no derivative financial instruments, ROMRS, related party financial liabilities and no foreign currency transactions or balances. The enterprise has not elected to use fair value for subsequent measurement of any financial instruments.

APPLICATION EXAMPLE

Note X Financial instruments and related risks
Financial assets include cash, accounts receivable and the amount due from a related enterprise. Financial liabilities include the bank indebtedness, trade accounts payable and long-term debt.

(a) Credit risk

Credit risk refers to the risk that a counterparty may default on its contractual obligations resulting in a financial loss. The enterprise's credit risk is mainly related to accounts receivable. The enterprise provides credit to its clients in the normal course of operations and there has been no change to credit risk exposures from the previous period.

(b) Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of the enterprise's financial instruments will fluctuate because of changes in market interest rates. The long-term debt has a fixed interest rate so a change in market interest rates does not impact the cash flows to service this debt. A change in the market interest rate can change the interest rate risk, but this exposure is currently favourable as the fixed rate is lower than prevailing interest rates for similar debt. There has been a change in interest risk exposure from the previous period as market interest rates continue to increase. The enterprise does not have any significant interest rate risk related to variable interest rate liabilities.

(c) Liquidity risk

Liquidity risk is the risk that the enterprise will be unable to fulfill its obligations on a timely basis or at a reasonable cost. The enterprise's exposure to liquidity risk depends on the sale of goods and services, collection of accounts receivable, or raising funds to meet its obligations. Cash flow from operations provides a substantial portion of the enterprise's cash requirements. The enterprise's long-term debt is structured with regularly recurring payments secured by assets which limits the liquidity risk. There has been no change to liquidity risk exposures from the previous period.

Notes:

1. If all the risks did not change in the period, a general comment in the introduction to the risks, or at the end could state that "there has been no change to the risk exposures." In this example, the requirement to address whether there was a change in the risk exposure, was addressed individually as the interest rate risk changed due to the external environment.
2. The accounting policy for the recognition and measurement of financial instruments would also be disclosed either in the significant accounting policy note **or** included in the note related to financial instrument risks.

Paragraphs 3856.48 and **3856.49** require disclosures about derivatives including specific amounts as set out in Chapter 45, paragraphs 45-244 and 45-245. The following application example illustrates possible disclosures when an enterprise has significant foreign currency risk and has a forward exchange contract that is a derivative financial instrument, measured at fair value:

APPLICATION EXAMPLE

Foreign currency risk:

Foreign currency risk is the risk that the fair value or future cash flows of the enterprise's financial instruments will fluctuate because of changes in foreign exchange rates. The enterprise reports in Canadian dollars and completed transactions to purchase inventory in U.S. dollars and is therefore exposed to foreign currency risk on the related accounts payable.

At December 31, 20X2, $230,000 (US$170,370) of trade accounts payables (20X1 – $180,000 [US$137,405]) is denominated in U.S. dollars.

At December 31, 20X2, the enterprise holds a forward exchange contract for settlement on February 28, 20X3, to purchase US$200,000 at $1.31. At December 31, 20X2, this financial asset is measured at a fair value of $8,123 based on the price quote provided by the enterprise's bank, the counterparty to the forward exchange contract.

The enterprise does not apply hedge accounting. There has been no significant change to foreign currency risk exposure from the previous period.

Disclosure: Concentrations of risk

The disclosure of concentrations of risks is specified in **paragraph 3856.54**. The application guidance in **paragraph 3856.A67** clarifies that an enterprise separately discloses the exposure to risks arising from each concentration of counterparties, if an enterprise's counterparties are concentrated:

- in one or more **industry sectors** (such as retail or wholesale)
- in one or more **credit qualities** (such as secured loans or unsecured loans) or **credit ratings** (such as investment grade or speculative grade)
- in one or more **geographical markets** (such as province or country)
- to a limited number of **individual counterparties** or groups of closely **related counterparties**

Similar principles apply to identifying concentrations of other risks, including liquidity risk and market risk. For example, concentrations of liquidity risk may arise from the:

- **repayment terms** of financial liabilities (such as when many financial liabilities have similar maturity dates)
- **sources of borrowing facilities** (such as when access to alternative financing sources is limited)
- **reliance on a particular market** in which to realize liquid assets (such as when there are limits or penalties for early redemption of short-term liquid assets)

Concentrations of foreign exchange risk may arise if an enterprise has a significant net open position in a single foreign currency, or aggregate net open positions in several currencies that tend to move together.

The following application examples illustrate possible disclosures for concentration of credit risk:

APPLICATION EXAMPLES

Example 1 - The accounts receivable originates from customers in the private and public sector, with the public sector accounting for approximately 75 per cent of the accounts receivable. The repayment terms on public sector receivables are often extended due to government budgeting processes and changes in government, and therefore the enterprise may be exposed to a significant credit and liquidity risk.

Example 2 - The enterprise is exposed to credit risk concentration since the majority of its accounts receivable are from customers operating in the Canadian film production industry.

Additional application resources

CPA Canada

ASPE briefing: Retractable or mandatorily redeemable shares issued in a tax planning arrangement

ASPE alert: Accounting for related party financial instruments and significant risk disclosures

Accounting Standards Board

Private Enterprise Advisory Committee meetings – notes by meeting date

Retractable or mandatorily redeemable shares issued in a tax planning arrangement – podcast series

Amendments to Section 3856, Financial instruments – on-demand webinar – on demand webinar

Domestic Accounting Standards Update (Winter 2022): Addresses retractable or mandatorily redeemable shares, and other topics – on demand webinar

Feedback

If you have comments on this Update to Chapter 45, please send them to:

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