

GUIDE TO ACCOUNTING STANDARDS FOR PRIVATE ENTERPRISES

CHAPTER 45

SECTION 3856, FINANCIAL INSTRUMENTS

In December 2018, Section 3856, *Financial Instruments* was amended in the *CPA Canada Handbook – Accounting*, with the amendments effective for years beginning on or after January 1, 2020. As a result of the COVID-19 health pandemic, the Accounting Standards Board is deferring the effective date of the amendments to this Section by one year to be effective for years beginning on or after January 1, 2021. Early application is permitted. Further details on this and decisions related to other amendments to the *CPA Canada Handbook – Accounting* can be found in the [Accounting Standards Board April 15, 2020 Decision Summary](#).

DISCLAIMER

This publication was prepared by the Chartered Professional Accountants of Canada (CPA Canada) as non-authoritative guidance.

CPA Canada and the authors do not accept any responsibility or liability that might occur directly or indirectly as a consequence of the use, application or reliance on this material.

Copyright © 2020 Chartered Professional Accountants of Canada.

All rights reserved. This publication is protected by copyright and written permission is required to reproduce, store in a retrieval system or transmit in any form or by any means (electronic, mechanical, photocopying, recording or otherwise). For information regarding permission, please contact permissions@cpacanada.ca

INTRODUCTION

This publication has been produced in response to requests for guidance on the application of Section 3856, Financial Instruments in Part II of the CPA Canada Handbook – Accounting.

CPA Canada expresses its appreciation to the principal authors of the publication, Jane Bowen, FCPA, FCA, Mark Walsh, FCPA, FCA, Dina Georgious, CPA, CA and the staff of the Canadian Accounting Standards Board for their technical review.

The guidance and illustrative examples provided are not authoritative. All decisions on the application of any accounting standard need to be made based on a thorough understanding of the facts and circumstances of each transaction and through the application of professional judgment.

The guidance in this publication is current as of August 2019. Judgment will need to be applied as practice evolves or Section 3856 is updated.

A handwritten signature in black ink, appearing to read "Gordon Beal".

Gordon Beal, CPA, CA, M.Ed

Vice President, Research, Guidance & Support

Chapter 45

Part II of the CPA Canada Handbook – Accounting

Section 3856, Financial Instruments

Contents

PURPOSE AND SCOPE.....	3
Contingent Consideration in a Business Combination	4
OVERVIEW OF KEY REQUIREMENTS	5
DEFINITIONS	7
RECOGNITION.....	8
Liability or Equity Classification.....	11
Compound Financial Instruments.....	13
MEASUREMENT.....	14
Initial Measurement – Arm's Length Transactions.....	15
Transaction costs.....	15
Demand loans.....	17
Loans at non-market interest rates	19
Initial Measurement – Related Party Transactions	20
Initial Measurement – Convertible Financial Liabilities.....	25
Initial Classification and Measurement – Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement.....	26
Tax accounting implications – ROMRS	42
Summary of initial measurement	43
Subsequent Measurement.....	45
Indexed financial liabilities	46
Cost / amortized cost.....	48
Amortization of initial purchase premium or discount, financing fees and transaction costs	49
Interest, dividends, losses and gains.....	52
Impairment	52
Overview.....	52
Assessment of individual assets or a group of assets for impairment	53
Indicators of impairment.....	53
Measurement of impairment	55
Reversal of impairment loss.....	59
FORGIVENESS	62
PRESENTATION	62
Offsetting.....	62

Legal right of offset.....	63
Intent to settle net.....	63
DERECOGNITION.....	63
Financial Assets.....	64
Measurement of interest held after a transfer of receivables.....	66
Servicing assets and liabilities	68
Sales-type and direct financing of lease receivables	74
Financial Liabilities	75
Extinguishment of financial liabilities	75
Extinguishment of financial liabilities between related parties.....	75
Modification of line of credit or other revolving debt arrangement.....	79
Extinguishing financial liabilities with equity instruments.....	81
Convertible financial liabilities	81
HEDGE ACCOUNTING	85
Hedged Item	87
Hedging Item.....	87
Accounting for the Hedging of Anticipated Transactions	89
Critical terms match.....	91
Currency Hedge.....	94
Hedge of interest rate risk	95
Cross-currency interest rate swap	97
Hedge of the net investment in a self-sustaining foreign operation	97
Illustrative Examples of Hedge Accounting	98
Discontinuance of Hedge Accounting	106
DISCLOSURE	107
Financial Assets.....	108
Accounts and notes receivable.....	109
Transfers of receivables	111
Impairment.....	112
Forgiveness	113
Financial Liabilities	113
Note Disclosure for ROMRS.....	116
Derivatives.....	117
Hedge Accounting	118
Items of Income.....	119
Risks and Uncertainties	120
EFFECTIVE DATE AND TRANSITION	122
Transition for new Guidance on ROMRS	125
APPLICATION RESOURCES	127

CURRENT DEVELOPMENTS.....	128
Recent Revisions	128
Projects and Discussions.....	128
APPENDIX A – DEFINITIONS.....	129
APPENDIX B – FAIR VALUE	133

PURPOSE AND SCOPE

- 45-1. FINANCIAL INSTRUMENTS, Section 3856 is a comprehensive standard on financial instruments applicable to both arm’s length and related party transactions. The Section is described as follows:

Paragraph 3856.01 This Section establishes standards for:

- (a) recognizing and measuring financial assets, financial liabilities and specified contracts to buy or sell non-financial items;
- (b) the classification of financial instruments, from the perspective of the issuer, between liabilities and equity;
- (c) the classification of related interest, dividends, losses and gains;
- (d) the circumstances in which financial assets and financial liabilities are offset;
- (e) when and how hedge accounting may be applied; and
- (f) disclosures about financial assets and financial liabilities.

- 45-2. Section 3856 applies to most types of financial instruments; however, it does exclude certain financial instruments addressed in other sections of the Handbook, as noted in the following paragraphs:

Paragraph 3856.03 An enterprise applies this Section to all financial instruments except the following:

- (a) interests in subsidiaries, enterprises subject to significant influence, and joint arrangements that are accounted for in accordance with SUBSIDIARIES, Section 1591, INVESTMENTS, Section 3051, and INTERESTS IN JOINT ARRANGEMENTS, Section 3056, although this Section applies to a derivative that is based on such an interest;
- (b) leases (see LEASES, Section 3065), although Appendix B applies to transfers of lease receivables;
- (c) employer's rights and obligations for employee future benefits and related plan assets (see EMPLOYEE FUTURE BENEFITS, Section 3462);
- (d) insurance contracts, including the cash surrender value of a life insurance policy;
- (e) investments held by an investment company that are accounted for at fair value in accordance with ACCOUNTING GUIDELINE AcG-18,

Investment Companies, although the disclosure requirements in paragraphs 3856.37-.54 apply to an investment company;

- (f) contracts and obligations for stock-based compensation to employees and stock-based payments to non-employees (see STOCK-BASED COMPENSATION AND OTHER STOCK-BASED PAYMENTS, Section 3870);
- (g) guarantees, other than guarantees that replace financial liabilities as described in paragraph 3856.A58 (see also ACCOUNTING GUIDELINE AcG-14, Disclosure of Guarantees);
- (h) contracts based on revenues of a party to the contract;
- (i) loan commitments (see CONTRACTUAL OBLIGATIONS, Section 3280, and CONTINGENCIES, Section 3290);
- (j) contractual arrangements that prevent sale treatment (for example, an option to repurchase transferred receivables); and
- (k) contracts issued by an acquirer (but not the seller) for contingent consideration in a business combination until such time as the contingency is resolved (see BUSINESS COMBINATIONS, paragraphs 1582.41-.42). This exception applies only to the acquirer (the enterprise that is accounting for the combination) and not to the seller.

Paragraph 3856.04 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.

Contingent Consideration in a Business Combination

45-3. As indicated in paragraph 3856.03(k) above, obligations of an acquirer for contingent consideration in a business combination are not within the scope of Section 3856 until the contingency is resolved. Such contingent consideration is initially measured in accordance with BUSINESS COMBINATIONS, Section 1582 and is not remeasured until the contingency is resolved.

45-4. BUSINESS COMBINATIONS, Section 1582 provides additional guidance on measurement of contingent consideration as follows:

Paragraph 1582.60 Some changes in the fair value of contingent consideration that the acquirer recognizes after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date. Such changes are measurement period adjustments in accordance with paragraphs 1582.47-.51. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, are not

measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

- (a) Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.
- (b) Contingent consideration classified as an asset or a liability shall be remeasured at fair value when the contingency is resolved, with any gain or loss recognized in net income. The resulting asset or liability, if a financial instrument shall be accounted for subsequently, in accordance with financial instruments, Section 3856, with any gain or loss recognized in net income.

OVERVIEW OF KEY REQUIREMENTS

- 45-5. The following table provides a high-level overview of the key requirements of Section 3856. The intent of the table is to walk the reader through the main requirements of Section 3856, identify areas where detailed guidance is given and complexity in application exists. Areas of greater complexity will be covered in more detail later in this chapter.

KEY REQUIREMENTS OF SECTION 3856
Recognition (3856.06)
Section 3856 requires financial instruments to be recognized when an entity becomes a party to a contract involving financial instruments.
Measurement (3856.06A-.19B)
For arm's length transactions , Section 3856 requires a financial instrument to be initially measured as follows: <ul style="list-style-type: none"> a) at fair value if it will be subsequently measured at fair value b) at fair value adjusted by any related transaction costs and financing fees if it will be subsequently measured at cost / amortized cost c) in accordance with the specific requirements for retractable or mandatorily redeemable shares (ROMRS) issued in a tax planning arrangement. (For convenience, this chapter will use ROMRS when referring to retractable or mandatorily redeemable shares assuming the shares were issued in a tax planning arrangement. ROMRS are discussed separately later in this chapter.)
For related party transactions , Section 3856 requires (with some exceptions) financial instruments to be initially measured at cost. The cost of a financial instrument issued in a related party transaction depends on whether the instrument has repayment terms.
When the financial instrument has repayment terms, the cost is determined using the undiscounted cash flows (excluding interest and dividend payments) less any impairment losses previously recognized by the transferor. When there are no repayment terms, the cost is determined using the consideration transferred or received.

For **subsequent measurement**, Section 3856 requires a financial instrument to be measured as follows:

- a) at fair value if the financial instrument was initially measured at fair value and
 - i) the instrument is an investment in equity instruments quoted on an active market or certain derivative contracts or
 - ii) the entity elects to use fair value measurement.
- b) all other financial instruments are subsequently measured using cost, amortized cost or the cost method depending on the nature of the instrument.

Presentation (3856.19C-.24)

Section 3856 provides guidance on classifying a financial instrument (or its component parts) as a liability or as part of equity based on the substance of the arrangement.

The component of a financial liability convertible to equity must be recognized separately. However, Section 3856 provides a policy choice to permit measuring the equity component at zero. If this measurement option is not chosen, the equity component may be measured using a rational method, such as the residual method or the relative fair value method.

Section 3856 permits ROMRS issued in a tax planning arrangement to be presented at par, stated or assigned value as a separate line item in the equity section of the balance sheet if certain criteria are met. If such criteria are not met, the shares are classified as a liability.

A financial asset may be offset with a financial liability only when both the following criteria have been met:

- a) The entity currently has a legally enforceable right of offset.
- b) The entity intends to settle on a net basis or to realize the items simultaneously.

Hedge accounting (3856.30-.36)

Hedge accounting is optional and only permitted under specific circumstances. Hedge accounting is allowed only when an entity has reasonable assurance the critical terms of the hedging item and hedged item are the same.

Specific details of the hedging relationship must be documented. When hedge accounting is achieved, accounting for the hedging item is modified. Hedge accounting cannot be electively discontinued; however, it is discontinued when the critical terms of the hedged item and the hedging item no longer match.

Disclosure (3856.37-.54)

Generally, information that enables users to evaluate the significance of financial instruments on the financial position and performance of an entity must be disclosed.

Appendices

Section 3856 is a comprehensive standard and includes the following appendices:

- Appendix A to Section 3856 – Application Supplement
- Appendix B to Section 3856 – Transfers of Receivables

DEFINITIONS

45-6. The definitions of a financial asset and financial liability are included in paragraph 3856.05 and summarized in the table below, along with corresponding examples of financial assets, financial liabilities and items excluded from the scope of Section 3856. It should be noted that Section 3856 includes additional definitions in paragraph 3856.05 and within Appendix A and Appendix B of the Section. The full list of definitions from paragraph 3856.05 are included in Appendix A of this chapter.

Definitions	Examples	Examples of items that are <i>not</i> in scope of Section 3856
<p>A financial asset is any asset that is:</p> <ul style="list-style-type: none"> • 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 potentially favourable conditions • an equity instrument of another entity (see paragraph 3856.05(h)) 	<ul style="list-style-type: none"> • cash • demand and fixed-term deposits • commercial paper • bankers' acceptances • treasury notes and bills • accounts, notes and loans receivable • bonds and similar debt instruments held as investments • common and preferred shares and similar equity instruments held as investments • loans to related parties • some options, warrants, futures contracts, forward contracts, and swaps if potentially favourable (see paragraphs 3856.02 and 3856.05(h)(iii)) 	<ul style="list-style-type: none"> • prepaid expenses • inventories • property, plant and equipment • leased rights and assets (see paragraph 3856.03(b)) • intangible assets such as patents and trademarks • income taxes • investments in subsidiaries, entities subject to significant influence or joint arrangements (see paragraph 3856.03(a)) • contracts issued by an acquirer (not the seller) for contingent consideration in a business combination until such time as the contingency is resolved (see paragraph 3856.03(k)) • costs incurred by an entity to purchase a right to reacquire its own equity instruments from another party; this is a deduction from equity (see paragraph 3856.05(h))
<p>A financial liability is any liability that is a contractual obligation:</p> <ul style="list-style-type: none"> • to deliver cash or another financial asset to another party • to exchange financial instruments with another 	<ul style="list-style-type: none"> • accounts, notes and loans payable (see paragraph 3856.02(d)) • loans from a related party • bonds and similar debt instruments issued (see paragraph 3856.02(e)) 	

Definitions	Examples	Examples of items that are <i>not</i> in scope of Section 3856
party under conditions potentially unfavourable to the entity	<ul style="list-style-type: none"> • in some cases, preferred shares, shares in co-operative organizations and interests in partnerships, and similar equity instruments issued are in substance financial liabilities (see paragraph 3856.20 and 3856.05(j)) • some options, warrants, futures contracts, forward contracts, and swaps if unfavourable (see paragraph 3856.02 and 3856.05(j)(ii)) 	


RECOGNITION

- 45-7. Section 3856 requires recognition of financial assets and liabilities when an enterprise becomes a party to the contractual provisions as specified in paragraph 3856.06:


Paragraph 3856.06 *An enterprise shall recognize a financial asset or a financial liability when the enterprise becomes a party to the contractual provisions of the financial instrument.*

- 45-8. Financial instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements. Recognition of a financial asset under Section 3856 depends on whether the asset meets the definition of a financial asset (usually based on **contractual** rights), though cash and equity investments are also financial assets. The recognition of a financial liability depends on the definition of a financial liability, which includes a contractual obligation. Therefore, the first step in recognition of a financial asset or liability is to assess whether the financial instrument meets the definition of a financial asset or liability as defined in Section 3856. In addition, it must be determined whether the financial instrument is excluded from the application of Section 3856 as discussed above and in paragraphs 3856.03 and .04.
- 45-9. As mentioned above, a financial instrument is initially recognized in the financial statements when the entity becomes party to the contractual provisions of the financial instrument. For example, financial instruments, such as trade receivables, are recorded when the underlying transaction is accounted for in accordance with the revenue standard (see Chapter 33 of this *Guide*).

- 45-10. When a financial instrument is purchased or sold (i.e., the purchase or sale of a stock or bond) on the open market, the AcSB concluded that the trade date most accurately reflects the economic effects of the transaction and is the recognition date that best provides transparency for derivatives. Due to clearing of some transactions, the trade date and the date the transaction is settled can be different. This has created some differences in practice (i.e., the settlement date is sometimes used to recognize the financial instrument). The following Application Example demonstrates recognition and measurement of a financial asset based on trade date accounting:

APPLICATION EXAMPLE				
	<p>On December 30, 20X1, Buy Co. purchased 100 shares of an unrelated company for their fair value amount of \$100. The transaction was settled on January 2, 20X2, at which time Buy Co. received and paid for the shares. By December 31, 20X1, the fair value of the shares had increased to \$115 and, by the time the transaction settled on January 2, 20X2, their fair value had grown to \$125.</p>			
	<p>Transaction costs are ignored in this example and discussed later in this chapter. The example includes subsequent measurement of the purchase under both cost and fair value (to be discussed later in this chapter). The appropriate journal entries are as follows:</p>			
	<p>Subsequent measurement at cost (i.e., investment in private company shares)</p>		<p>Subsequent measurement at fair value (i.e., investment in public company shares are quoted in an active market)</p>	
	December 30, 20X1			
	Dr. Investment in shares	\$100	Dr. Investment in shares	\$100
	Cr. Payable	\$100	Cr. Payable	\$100
	December 31, 20X1			
	No entry		Dr. Investment in shares	\$15
			Cr. Unrealized fair value increase	\$15
	January 2, 20X2			
Dr. Payable	\$100	Dr. Payable	\$100	
Cr. Cash	\$100	Cr. Cash	\$100	
		Dr. Investment in shares	\$10	
		Cr. Unrealized fair value increase	\$10	

- 45-11. While trade date accounting is preferred by the AcSB, recognition on the settlement date (settlement date accounting) may also be used. In this case, the transaction is recorded at the settlement date, not the trade date. The following Application Example demonstrates settlement date accounting:

APPLICATION EXAMPLE				
	<p>On December 30, 20X1, Buy Co. purchased 100 shares of an unrelated company for their fair value amount of \$100. The transaction was settled on January 2, 20X2, at which time Buy Co. received and paid for the shares. By December 31, 20X1, the fair value of the shares had increased to \$115 and, by the time the transaction settled on January 2, 20X2, their fair value had grown to \$125. The appropriate journal entries are as follows:</p>			
	<p>Subsequent measurement at cost (i.e., investment in private company shares)</p>		<p>Subsequent measurement at fair value (i.e., investment in public company shares are quoted in an active market)</p>	
	December 30, 20X1			
	No entry		No entry	
	December 31, 20X1			
	No entry		No entry	
	January 2, 20X2			
	Dr. Investment in shares	\$100	Dr. Investment in shares	\$100
	Cr. Cash	\$100	Cr. Cash	\$100
			Dr. Investment in shares	\$25
		Cr. Unrealized fair value increase	\$25	

- 45-12. If the transaction trade date and settlement date are within the same reporting period, there is no difference in reported net income using either the trade date or settlement date methods of accounting. However, if the fiscal reporting period falls in between the trade date and settlement date, the income statement would change depending on the selected accounting method. The balance sheet would also be different (even when the investment is in private company shares and measured at cost) due to the date at which the investment and liability are recorded. Since the transaction creates the financial liability, the trade date best reflects the economic effects of the transaction.

Liability or Equity Classification

- 45-13. The recognition of an issued (i.e., not purchased or acquired) financial instrument also involves determining the appropriate classification of such instrument. The substance of the contractual terms of a financial instrument rather than its legal form governs its classification on the issuer's balance sheet. Guidance on classifying an issued financial instrument as a financial liability or an equity instrument is included in Section 3856 as follows:
- Paragraphs 3856.20-.23AA
 - Paragraphs 3856.23-23AA specifically address the classification of ROMRS issued in a tax-planning arrangement, which are also discussed later in this chapter. Classification of other types of financial instruments is discussed further below.
- 45-14. In some cases, it may be difficult to determine whether a financial instrument should be considered a liability or equity instrument. For example, some financial instruments take the legal form of equity but are liabilities in substance because they require payment to the holder of the instrument of a fixed or determinable amount. Others may combine features associated with equity instruments and features associated with financial liabilities. Such combinations make it difficult to distinguish between equity or liability classification entirely.
- 45-15. To determine whether a financial instrument should be classified as a financial liability or equity instrument, consider the definitions of these instruments as noted in the following paragraphs:
- Paragraph 3856.05(e)** An **equity instrument** is any contract that evidences a residual interest in the assets of an enterprise after deducting all of its liabilities.
- Paragraph 3856.05(j)** A **financial liability** is any liability that is a contractual obligation:
- (i) to deliver cash or another financial asset to another party; or
 - (ii) to exchange financial instruments with another party under conditions that are potentially unfavorable to the enterprise.
- 45-16. The substance of the contractual terms of a financial instrument rather than its legal form governs its classification on the issuer's balance sheet. This determination is made on initial recognition of the instrument, disregarding any non-substantive or minimal features. The initial classification is not revised unless the terms of the financial instrument change. When considering whether the financial instrument or its component parts meet the definition of a financial liability, the existence of a restriction on the ability of the issuer to satisfy an obligation, (e.g., lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority) does not negate the issuer's obligation or the holder's rights under the instrument.
- 45-17. When an issuer has a contractual obligation to deliver a fixed amount or an amount that fluctuates either partially or fully in response to changes in a given variable (other

than the market price of the entity's own equity instruments), and the issuer is required to or is able to settle the contractual obligation by delivering enough of its own equity instruments, this would be considered a financial liability because the counterparty is guaranteed a fixed value that is not subject to the residual risk of the issuer. These contractual obligations may be established either explicitly or indirectly through an instrument's terms and conditions. For example, assume Company A is obligated to pay an amount equal to \$500,000 plus 5% of its sales from the prior year (which were \$100,000). The obligation of \$505,000 is a liability, even if Company A can settle it by issuing its own shares, and is valued as such.

- 45-18. When an instrument does not meet the definition of a liability (i.e., the issuer does not have a contractual obligation to deliver cash or another financial asset or financial instrument under potentially unfavourable conditions), the instrument is classified as equity. Based on the example in the previous paragraph, if Company A's obligation was to deliver 500 of its own shares, then the obligation would not be classified as a liability and would therefore be equity.
- 45-19. The holder of an equity instrument is usually entitled to receive a pro rata share of dividends or other distributions out of the equity of the issuer. If the issuer does not have a contractual obligation to make such distributions, then the issuer's instruments are classified as equity. Thus, the terms and conditions of some classes of shares may be such that they meet the definition of an equity instrument and are classified accordingly. The following clarification is provided on such items, including partnership interests:

Paragraph 3856.A27 Some financial instruments, such as partnership interests and certain types of shares in co-operative organizations, 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 paragraph 3856.A28, 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.

- 45-20. The classification of a financial instrument as either liability or equity is not revised based on a change in estimate of the probability of a future event occurring. If the future event occurs and the financial instrument still exists, it is derecognized and a new financial liability or equity instrument is recognized based on the remaining terms. Similarly, classification is not impacted by historical events or intentions but is decided based on the actual substance of the contractual arrangements. Factors outside the contractual terms are not considered when determining whether an instrument is to be classified as a liability or equity.

- 45-21. It should be noted that the possibility of an economic compulsion to settle in cash does not cause the instrument to be classified as a financial liability if there is no contractual obligation. This is noted in the following paragraph:

Paragraph 3856.A26A In the absence of a contractual obligation to redeem a financial instrument, economic compulsion does not cause the instrument to be classified as a financial liability.

- 45-22. Economic compulsion can be described as a situation whereby an entity may be compelled to take a particular course of action in the future because such action will be economically advantageous relative to available alternatives.
- 45-23. For example, private equity investors often attempt to build a liquidity mechanism into their investments by establishing a right that allows them, after a certain period of time, to have the issuing enterprise sold if a specified event or circumstance (e.g., an IPO) has not occurred. This right is a form of a "sale right" and its objective is to provide investors with leverage to recover on their investment. The issuing enterprise has the option to comply with the mechanisms of the sale right or, within a specified time frame, trigger a "call right" instead. This call right is the right, but not the obligation, of the enterprise to avoid the application of the sale right by purchasing the shares of the investors. The investors control the timing of the transaction because the enterprise cannot exercise the call right unless investors have first exercised their sale right. In this situation, it might be advantageous for the entity to redeem the investors' shares to prevent the expropriation of the enterprise or the common shares by the investors. However, since the issuing enterprise has no obligation to redeem the shares, they are equity and not, in substance, a liability.

Compound Financial Instruments


- 45-24. When a financial instrument is issued by an enterprise and contains both a liability and equity element, each element should be classified in accordance with its substance. The definitions of a financial liability and an equity instrument are considered in this classification. For example, a convertible financial instrument (e.g., convertible debt) is different in form but not in substance from a financial liability that is issued with detachable warrants or options. In both cases, the liability and equity components are accounted for separately. Measurement of the liability and equity components is discussed later in this chapter.
- 45-25. The separate classification based on the substance of the contractual terms of the arrangement still applies when a financial instrument contains components that are neither financial liabilities nor equity instruments of the issuer. For example, an instrument that gives the holder the right to receive a commodity (e.g., a fixed amount of gold) on settlement as well as an option to exchange the holder's right for shares of the issuer, contains both a liability and an equity element. The issuer recognizes and presents the equity element (i.e., the exchange option) separately from the liability component (i.e., the right to receive the gold commodity) of the instrument.

- 45-26. Once it has been determined that a financial asset, financial liability or compound instrument is to be recognized in accordance with Section 3856, the initial and subsequent measurement can be addressed.

MEASUREMENT

- 45-27. Before addressing the details on the measurement of financial instruments, some of the underlying principles guiding Section 3856 are provided below:
- Generally, financial instruments are **initially** measured at fair value, with some exceptions, including financial assets originated or acquired or financial liabilities issued or assumed in a related party transaction, and other specific exceptions, such as ROMRS issued in a tax-planning arrangement.
 - Generally, **subsequent measurement** of financial instruments is either at cost, amortized cost, cost method or fair value, depending on their nature.
 - The accounting for transaction costs on initial recognition depends on the subsequent measurement of the financial instrument.
 - Special accounting is provided in Section 3856 for qualifying hedging relationships.

- 45-28. The following Application Insight provides further discussion on the use of fair value:

APPLICATION INSIGHT	
	<p>Fair value is defined in paragraph 3856.05(f) as follows:</p> <p>Fair value is the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.</p> <p>In practice, this definition can be difficult to apply. The determination of the fair value of a financial instrument often requires professional judgment. Appendix B to this chapter provides some considerations and sources of fair value information and also includes some application examples.</p>

- 45-29. This chapter will review the initial measurement guidance in Section 3856 in the following order:
1. Initial Measurement – Arm's length transactions
 2. Initial Measurement – Related party transactions
 3. Convertible financial instruments
 4. ROMRS issued in a tax planning arrangement

Initial Measurement – Arm's Length Transactions

- 45-30. With the exception of ROMRS (discussed further below), financial instruments issued or acquired in arm's length transactions are initially measured at fair value. As fair value is the price an arm's length market participant would pay or receive in a routine transaction under market conditions at the time of initial recognition, a financial instrument's initial fair value will normally be the transaction price (i.e., the fair value of the consideration given or received). For purposes of Section 3856, parties whose sole relationship with an enterprise is in a management capacity (see Section 3840 or Section 4460) or are members of the immediate family of any individual to which this guidance applies, are deemed to be unrelated third parties.

Transaction costs


- 45-31. The general accounting treatment of transaction costs is to expense them, as provided in paragraph 3856.06A:

Paragraph 3856.06A *Except as specified in this Section, transaction costs shall be recognized in net income in the period incurred.*

- 45-32. As indicated above, there are exceptions in Section 3856. For example, the treatment of transaction costs directly attributable to the origination, acquisition, issuance or assumption of financial instruments depends on the subsequent measurement of the instrument. When the instrument will be subsequently measured at fair value, transaction costs are recorded in income in the period incurred (see paragraph 3856.12). This is because they are not part of the fair value of the financial instrument and do not meet the definition of an asset necessary for separate recognition. When the instrument will be subsequently measured at cost, amortized cost or using the cost method, transaction costs are included in the initial measurement of the instrument. This conclusion is also relevant for financing fees incurred in arm's length transactions, as indicated in paragraph 3856.07:


Paragraph 3856.07 *Except as specified in paragraph 3856.09A, when a financial asset is originated or acquired or a financial liability is issued or assumed in an arm's length transaction, an 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.*

- 45-33. The following Application Insight provides further discussion on transaction costs:

APPLICATION INSIGHT	
	<p>Sometimes there is confusion regarding financing fees and transaction costs associated with a financial instrument. Therefore, it is worthwhile to review the two definitions at once and understand the distinction between the two terms.</p> <p>Financing fees are amounts that compensate the lender for the risk of</p>

APPLICATION INSIGHT	
	<p>providing funds to the borrower. Financing fees (sometimes referred to as fees in lieu of interest), loan fees or financing costs, include:</p> <ul style="list-style-type: none"> • fees charged to originate, arrange or syndicate a loan or debt financing • commitment, standby and guarantee fees • refinancing, restructuring and renegotiation fees. <p>Financing fees may be refundable or non-refundable. Financing fees do not include transaction costs. (3856.05(g))</p> <p>Transaction costs are incremental costs directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the enterprise had not acquired, issued or disposed of the financial instrument. Transaction costs include expenditures such as legal fees, reimbursement of the lender's administrative costs and appraisal costs associated with a loan. Transaction costs do not include financing fees, debt premiums or discounts. (3856.05(p))</p> <p>In practice, financing fees and transaction costs are combined for recognition purposes since they are generally accounted for the same way. However, one way to keep the nature of these amounts separated is to remember that financing fees are “in lieu” of interest, whereas transaction costs are one-time costs incurred for the transaction.</p> <p>The general rule is that transaction costs are expensed (see 3866.06A), but the accounting for transaction costs depends on how the financial instrument will be subsequently measured. If subsequently measured at fair value, the financing and transaction costs are expensed (see 3856.07 for arm’s length transactions). However, if the financial instrument is subsequently measured at cost, the initial cost base is adjusted for the transaction costs. The related financial instrument is amortized on either the straight-line or effective interest rate method.</p> <p>It is also important to remember that transaction costs for strategic investments (i.e., those that will be accounted for using the equity or consolidation methods) will be expensed (see Chapters 13, 14, 15, 16 and 21 of this <i>Guide</i> for accounting for strategic investments).</p>

- 45-34. Financing fees and transaction costs included in the initial measurement of an interest-bearing instrument are amortized over the life of the instrument (see paragraphs 3856.07 and .A4). Standby fees and transaction costs associated with a line of credit or revolving debt arrangement are recognized as an asset and amortized over the life of the commitment because they are, in substance, analogous to an insurance premium. The fee is the cost associated with having the ability to draw down the loan over the term of the arrangement (see paragraph 3856.A57).
- 45-35. The following Application Example illustrates the accounting for an investment in equity instruments at cost:

APPLICATION EXAMPLE							
	<p>On February 14, 20X1, Investor Corp. invested \$10,000 in 10,000 common shares of Private Co., giving Investor Corp. a 10% voting interest. Investor Corp. and Private Co. are unrelated. The price paid for the acquisition of the common shares represents the fair value of the shares at the purchase date. Investor Corp. also incurred \$500 in legal fees to register the title of the shares in its name.</p> <p>The journal entry to record the share purchase is as follows:</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Dr. Investment in Private Corp.</td> <td style="width: 20%; text-align: right;">\$10,500</td> <td style="width: 20%;"></td> </tr> <tr> <td style="padding-left: 40px;">Cr. Cash</td> <td></td> <td style="text-align: right;">\$10,500</td> </tr> </table>	Dr. Investment in Private Corp.	\$10,500		Cr. Cash		\$10,500
Dr. Investment in Private Corp.	\$10,500						
Cr. Cash		\$10,500					

Demand loans

- 45-36. The fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date the amount could be required to be paid. The interest rate and the length of time until the payment date will determine the significance of discounting the liability. A debt instrument with no contractual repayment terms is deemed to be payable on demand. In practice, the initial fair value for such a liability is generally the price at which it originated between the customer and the lender (i.e., the demand amount). However, when the payment of a debt instrument is subordinated to the interest of another party, the earliest date at which payment could be demanded is the day following the maturity of the instrument to which it is subordinated.
- 45-37. The interest rate used to discount a financial instrument payable on demand should be the rate available to the entity on a similar financial instrument maturing on, or as close as possible to, the first date the instrument could be required to be paid. It incorporates any risk premium a third party would charge for a financial instrument of comparable credit quality and terms (see paragraph 3856.A13).
- 45-38. The following Application Example demonstrates the accounting for various types of loans and charges:

APPLICATION EXAMPLE



Example 1 – Term loan

Bank of Lenders agrees to lend Borrowing Corporation \$100,000 for five years, bearing annual interest at 6%, payable monthly, with principal repayable in full at maturity. Bank of Lenders is able to demand repayment of the loan at any time if specified conditions are not met. On issuance of the loan, Bank of Lenders charges Borrowing Corporation transaction costs of \$1,250 to write the loan and register collateral on it. Because at the end of year one the specified conditions are met, Bank of Lenders is not able to demand repayment of the loan.

Recording initial loan and fees entries:

Dr. Cash	\$98,750		
(\$100,000			
– \$1,250)			
Cr.		\$98,750	
Loan			
payable			

End of year one entries:

Dr. Interest	\$6,250		
expense*			
Cr.		\$250	
Loan			
payable			
Cr.		6,000	
Cash			

Example 2 – Demand loan with no terms of repayment

Borrowing Corporation arranges a demand loan with Bank of Lenders in the amount of \$100,000. Bank of Lenders is able to demand repayment of the loan at any time. The loan carries an annual interest rate of 6%. On issuance of the loan, the Bank of Lenders charges Borrowing Corporation a \$1,250 origination fee.

Dr. Cash	\$98,750		
Dr. Loan		1,250	
fees			
expense			
Cr.			\$100,000
Loan			
payable			

Dr. Interest	\$6,000		
expense**			
Cr. Cash		\$6,000	

Example 3 – Revolving line of credit

Borrowing Corporation arranges with Bank of Lenders to enter into a revolving line of credit with a limit of \$100,000. Bank of Lenders is able to demand repayment of the line at any time. The line carries an annual interest rate of 6%. On issuance of the line, Bank of Lenders charges Borrowing Corporation a \$1,250 annual standby fee. No amounts have been drawn on the line of credit as of the end of year one.

Dr. Prepaid	\$1,250		
asset			
Cr. Cash			\$1,250
Dr. Standby	\$1,250		
fees expense			
Cr. Prepaid			\$1,250
asset			


This example uses the straight-line amortization method, but the effective-interest method may also be used.

*Interest expense = (\$1,250/5) + (\$100,000 * 6%)


**Interest expense = \$100,000 * 6%

Loans at non-market interest rates

- 45-39. A loan with an interest rate significantly below the market rate indicates the stated transaction price may not represent the fair value of the transaction.
- 45-40. Similarly, a below-market-rate loan to an employee may represent additional compensation equal to the difference between the actual interest rate on the loan and the market rate.
- 45-41. The following Application Example illustrates the initial measurement of an arm's length loan with a non-market rate of interest used to make an asset purchase:

APPLICATION EXAMPLE					
	<p>On February 14, 20X1, Seller Corporation financed Customer Co.'s purchase of a \$1,000 machine by extending payment for three years. Interest was payable annually at 3%. The market rate of interest for a similar loan to an entity with Customer Co.'s credit rating was 5%.</p>				
	<p>The loan was initially measured at its fair value of \$946 (i.e., net present value of \$30 of annual interest for three years and principal repayment of \$1,000, both discounted at the market rate of 5%).</p>				
	<p>The transaction was recorded as follows:</p>				
	Date	Seller's books			Customer's books
February 14, 20X1	Dr. Loan receivable	\$946		Dr. Machine	\$946
		Cr. Revenue	\$946	Cr. Loan payable	\$946

- 45-42. The following Application Example illustrates the initial measurement of a non-interest-bearing loan to an employee:

APPLICATION EXAMPLE	
	<p>On January 1, 20X1, Mr. Manager received a non-interest-bearing five-year housing loan in the amount of \$25,000 from his employer, Bonus Corporation. Mr. Manager's sole relationship with Bonus Corporation was in his capacity as management. The loan was due in full January 1, 20X6. The prevailing market interest rate for a similar loan due in five years with a similar credit rating was 5%. Assume that continuation of employment was not required as a condition for the loan.</p> <p>Based on paragraph 3856.07A, Mr. Manager was deemed to be an unrelated third party because his sole relationship with Bonus Corporation was in his capacity as</p>

APPLICATION EXAMPLE										
	<p>management. Bonus Corporation measured the loan January 1, 20X1 at its fair value and recorded the following entry on initial recognition:</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Dr. Loan receivable (PV of \$25,000, n = 5, i = 5%)</td> <td style="text-align: right; width: 10%;">\$19,588</td> <td style="width: 10%;"></td> </tr> <tr> <td>Dr. Compensation expense (\$25,000 – \$19,588)</td> <td style="text-align: right;">5,412</td> <td></td> </tr> <tr> <td style="padding-left: 20px;">Cr. Cash</td> <td></td> <td style="text-align: right;">\$25,000</td> </tr> </table> <p>Mr. Manager was essentially receiving a non-interest-bearing housing loan as part of his employment compensation. The amount recognized as compensation expense in the above entry reflects the nature of the expense.</p> <p>If the loan conditions had required continuation of Mr. Manager’s employment, the compensation expense would have initially been recorded as a prepaid expense and amortized over the term of the loan.</p>	Dr. Loan receivable (PV of \$25,000, n = 5, i = 5%)	\$19,588		Dr. Compensation expense (\$25,000 – \$19,588)	5,412		Cr. Cash		\$25,000
Dr. Loan receivable (PV of \$25,000, n = 5, i = 5%)	\$19,588									
Dr. Compensation expense (\$25,000 – \$19,588)	5,412									
Cr. Cash		\$25,000								

Initial Measurement – Related Party Transactions

45-43. Section 3856 provides specific guidance on accounting for a financial asset originated or acquired, or a financial liability issued or assumed in a related party transaction. However, it is necessary to refer to Section 3840 to determine whether the parties in the transaction are related as well as for the measurement of the non-financial instrument element(s) exchanged and disclosure requirements of related party transactions (see Chapter 42 of this *Guide*).

45-44. The following definitions are included in Section 3856:

Paragraph 3856.05(ob) 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. Two not-for-profit organizations are related parties if one has an economic interest in the other. Related parties also include management and immediate family members (see RELATED PARTY TRANSACTIONS, paragraph 3840.04 or DISCLOSURE OF RELATED PARTY TRANSACTIONS BY NOT-FOR-PROFIT ORGANIZATIONS, paragraph 4460.04 in Part III of the Handbook, as applicable).

Paragraph 3856.05 (oc) A related party financial instrument is a contract between related parties that creates a financial asset for one enterprise and a financial liability or equity instrument of another enterprise.

Paragraph 3856.05 (od) 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.

- 45-45. When determining who is a related party, it important to recognize that parties whose sole relationship with the enterprise is in their capacity as management are deemed to be unrelated third parties for the purposes of applying Section 3856:

Paragraph 3856.07A For the purpose of this Section, parties whose sole relationship with the enterprise is in the capacity of management, as defined in RELATED PARTY TRANSACTIONS, paragraph 3840.04(d) or DISCLOSURE OF RELATED PARTY TRANSACTIONS BY NOT-FOR-PROFIT ORGANIZATIONS, paragraph 4460.04(e), 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.

- 45-46. Section 3856 requires measurement at fair value without any adjustment for certain financial instruments as follows:

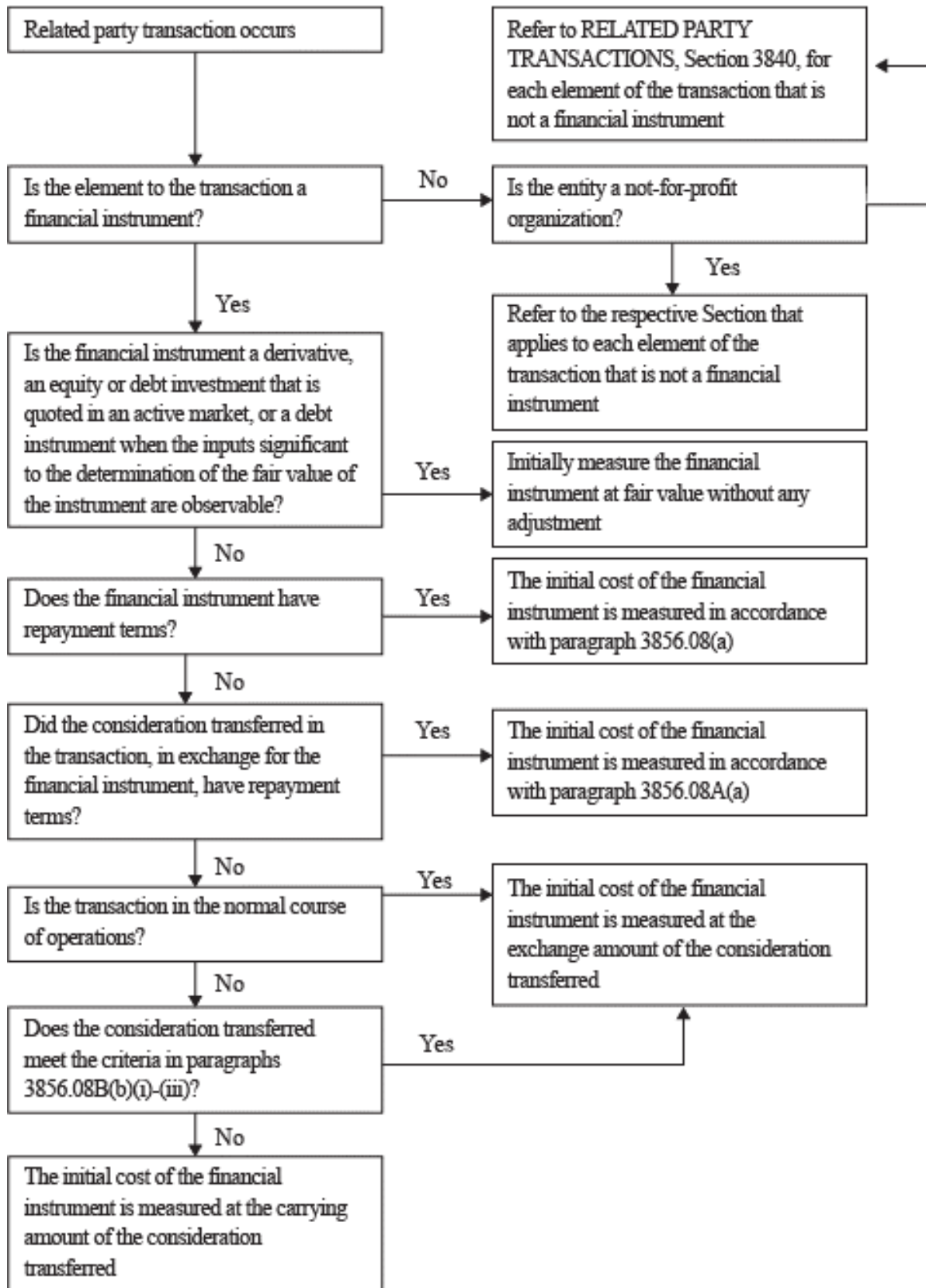
Paragraph 3856.08C *An enterprise shall initially measure the following financial instruments originated or acquired or issued or assumed in a related party transaction at fair value without any adjustments:*

- (a) investments in equity instruments that are quoted in an active market;*
- (b) debt instruments that are quoted in an active market;*
- (c) debt instruments when the inputs significant to the determination of the fair value of the instrument are observable, either directly or indirectly (Paragraph 3856.A8J provides related application guidance.); and*
- (d) derivative contracts.*


- 45-47. Except as noted in the previous paragraph, financial assets originated or acquired or financial liabilities issued or assumed in a related party transaction are initially measured at cost. When a financial instrument has repayment terms, cost is determined using undiscounted cash flows of the financial instrument, excluding interest and dividend payments, less any impairment losses previously recognized by the transferor. When a financial instrument does not have repayment terms, cost is determined using the consideration transferred by the enterprise in the transaction.

- 45-48. Repayment terms may be in written or oral form. Examples of financial instruments having repayment terms include:
- trade accounts receivable and payable
 - notes receivable and payable
 - loans receivable and payable
 - bonds receivable and payable
 - debt instruments with no stated repayment terms deemed to be payable on demand
 - ROMRS.


- 45-49. Examples of financial instruments having no repayment terms include:
- common shares
 - warrants
 - preferred shares without a stated redemption amount
 - options.
- 45-50. Except for ROMRS issued in a tax-planning arrangement, when a related party transaction includes a financial instrument and is in the normal course of operations, or is not in the normal course of operations and
- the transaction is a monetary transaction or non-monetary transaction with commercial substance
 - the change in the ownership interests in the items transferred is substantive and
 - the transaction amounts for each element in the transaction is supported by independent evidence
- any gain or loss on initial measurement is included in net income, unless another Section requires alternative treatment. Otherwise, any difference resulting from the transaction is recorded in equity.
- 45-51. A non-monetary related party transaction has commercial substance when the enterprise's future cash flows are expected to change significantly. The enterprise's future cash flows are expected to change significantly when:
- the configuration of the future cash flows of the asset received differs significantly from the configuration of the future cash flows of the asset given up or
 - the enterprise-specific value of the asset received differs from the enterprise-specific value of the asset given up and the difference is significant in relation to the exchange amount of the items exchanged.
- 45-52. The configuration of future cash flows is composed of the risk, timing and amount of the cash flows. A change in any one or more of these factors is considered a change in the configuration.
- 45-53. The following decision tree outlines initial measurement for a financial instrument issued in a related party transaction:



- 45-54. The following Application Example demonstrate the initial measurement of a debt instrument exchanged in a related party transaction:

APPLICATION EXAMPLE					
	<p>Initial Measurement of a Debt Instrument – Related Party Transaction</p> <p>Company A and Company B are related parties. Company A provides \$200,000 to Company B in exchange for a note receivable that is not quoted in an active market, does not have observable inputs to the determination of its fair value and does not have any stated terms of repayment.</p> <p>(Financial asset to Company A and financial liability to Company B)</p> <p>Company A</p> <p>The initial measurement of the note receivable is at cost. The fair value criteria noted earlier in this chapter are not met (i.e., the debt instrument is not quoted in an active market, inputs significant to the determination of its fair value are not observable).</p> <p><i>Cost is determined based on the terms of repayment. A financial instrument with no stated terms of repayment is deemed to be due on demand. Accordingly, cost is determined using the undiscounted cash flows (excluding interest and dividends) of the financial instrument (in this case, the face value of the note of \$200,000).</i></p> <p><i>Company A records the note receivable at a cost of \$200,000:</i></p> <table style="margin-left: auto; margin-right: auto;"> <tr> <td style="padding-right: 40px;">Dr. Note receivable</td> <td style="text-align: right;">\$200,000</td> </tr> <tr> <td style="padding-right: 40px;">Cr. Cash</td> <td style="text-align: right;">\$200,000.</td> </tr> </table> <p>Company B</p> <p>For the same reasons noted above, Company B recognizes an increase in cash of \$200,000, with a corresponding increase in liabilities (i.e., note payable).</p>	Dr. Note receivable	\$200,000	Cr. Cash	\$200,000.
Dr. Note receivable	\$200,000				
Cr. Cash	\$200,000.				

- 45-55. The following Application Example demonstrate the initial measurement of common shares exchanged in a related party transaction:

APPLICATION EXAMPLE	
	<p>Initial Measurement of Common Shares – Related-Party Transaction</p> <p>Company G and Company E are related parties held under common control by Company C. Company G transferred land to Company E and received common shares in Company E as consideration for the land. The common shares of Company E are not traded in an active market.</p> <p>Prior to the transaction, the carrying value of the land in the accounts of Company G was \$300,000. The exchange amount of the land was \$500,000.</p> <p>The journal entries by the seller, Company G, will depend on whether the financial instrument is measured at the carrying amount or exchange amount of the consideration transferred (in this case, the land):</p>

APPLICATION EXAMPLE	
Case 1 – Initial measurement at carrying amount	
Dr. Investment in Company E	\$300,000
Cr. Land	\$300,000
 Case 2 – Initial measurement at exchange amount	
Dr. Investment in Company E	\$500,000
Cr. Land	\$300,000
Cr. Gain	200,000
<p>Since the shares in Company E are not traded in an active market and there are no repayment terms in the transaction, the cost of the investment in Company E is either the carrying amount (Case 1) or the exchange amount, with the gain being recognized in income (Case 2). The use of the carrying or exchange amount will depend on whether the criteria set out in paragraphs 3856.08B and 08E have been met.</p>	


Initial Measurement – Convertible Financial Liabilities

- 45-56. Private enterprises may issue debt that includes an option for the debt holder to acquire equity of the issuer under specific circumstances (i.e., a compound instrument). These options are similar in nature to detachable options or warrants.
- 45-57. Section 3856 provides an accounting policy choice that allows the equity component of a convertible financial instrument to be measured as zero or to be based on fair value measurements (explained below). To ensure financial statement users are aware of the terms of the conversion option, it is especially important to disclose the terms of a convertible financial instrument when the zero-measurement alternative is chosen.
- 45-58. For a financial instrument issued in an arm's length transaction, acceptable methods for initial measurement of the liability and equity components of a convertible financial instrument are:
- The equity component is measured as zero; the entire proceeds of the issuance are allocated to the liability component.
 - The less easily measurable component is allocated the residual amount after deducting from the entire proceeds of issuance the amount separately determined for the component more easily measurable. The sum of the carrying amounts assigned to each component on initial recognition must always equal the carrying amount that would be ascribed to the instrument as a whole. No gain or loss is realized from recognizing and presenting the components of the convertible instrument separately.

45-59. For a financial instrument issued in a related party transaction, acceptable methods for initial measurement of the liability and equity components of a convertible financial instrument are:

- The equity component is measured at zero; the entire proceeds of the issuance are allocated to the liability component.
- The equity component is allocated the residual amount after deducting from the entire proceeds of issuance the amount separately determined for the liability component. The sum of the carrying amounts assigned to each component on initial recognition must always equal the carrying amount that would be ascribed to the instrument as a whole. No gain or loss is realized from recognizing and presenting the components of the convertible instrument separately.

45-60. The following Application Example illustrates the initial measurement of a convertible financial liability issued in an arm's length transaction:

APPLICATION EXAMPLE																
	<p>Capital Corporation needs to raise \$10,000 to fund its operation and issues bonds in the aggregate amount of \$10,000. The bonds are repayable in five years with an annual interest rate of 6%. The bonds are convertible at the option of the holder into a fixed number of common shares of Capital Corporation. The Black-Scholes Model determines the conversion feature fair value of the bonds is \$250 upon initial issuance.</p> <p><i>Option 1 – Conversion feature is measured at zero</i></p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Dr. Cash</td> <td style="width: 20%; text-align: right;">\$10,000</td> <td style="width: 20%;"></td> </tr> <tr> <td style="padding-left: 20px;">Cr. Liability</td> <td></td> <td style="text-align: right;">\$10,000</td> </tr> </table> <p><i>Option 2 – Conversion feature is measured at fair value and the liability is allocated the residual amount</i></p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Dr. Cash</td> <td style="width: 20%; text-align: right;">\$10,000</td> <td style="width: 20%;"></td> </tr> <tr> <td style="padding-left: 20px;">Cr. Liability (\$10,000 – \$250)</td> <td></td> <td style="text-align: right;">\$9,750</td> </tr> <tr> <td style="padding-left: 20px;">Cr. Equity (conversion feature)</td> <td></td> <td style="text-align: right;">250</td> </tr> </table>	Dr. Cash	\$10,000		Cr. Liability		\$10,000	Dr. Cash	\$10,000		Cr. Liability (\$10,000 – \$250)		\$9,750	Cr. Equity (conversion feature)		250
Dr. Cash	\$10,000															
Cr. Liability		\$10,000														
Dr. Cash	\$10,000															
Cr. Liability (\$10,000 – \$250)		\$9,750														
Cr. Equity (conversion feature)		250														

Initial Classification and Measurement – Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement

45-61. Paragraph 3856.09A requires that an enterprise initially measure ROMRS issued in a tax planning arrangement that are classified as:

- equity, at their par, stated or assigned value or
- a financial liability, at their redemption amount.


45-62. Generally, ROMRS meet the definition of a liability in Section 1000, FINANCIAL STATEMENT CONCEPTS. However, Section 3856 permits ROMRS issued in a tax

planning arrangement to be presented as equity when all the following conditions are met:

- Control of the enterprise issuing the shares is retained by the shareholder receiving the shares
- In the arrangement:
 - No consideration is received by the enterprise issuing the shares or
 - Only shares of the enterprise issuing the ROMRS are exchanged and
- No written or oral agreement (e.g., a redemption schedule) exists that gives the shareholder the contractual right to require the enterprise to redeem the shares on a fixed or determinable date or within a fixed or determinable period.


45-63. If all these criteria are met, the issuer may present the ROMRS as a separate line item in equity at par, stated or assigned value. The issuer may also present the ROMRS as a financial liability: it is a choice. These criteria are discussed in greater detail below.

45-64. The following Application Insight provides further clarification on the classification choice for ROMRS:

APPLICATION INSIGHT	
	<p>Paragraph 3856.23A provides an option to classify ROMRS as either a financial liability or equity. The question that may come up is whether that option is to be applied on a per share basis, per class of share basis, per tax planning arrangement basis or if it is a policy choice.</p> <p>For example, Class B ROMRS are issued in a transaction on day one and a choice is made to classify those shares as a liability. Five years later, a second tax planning arrangement is completed, and Class B ROMRS are issued. If on day one the first set of ROMRS was classified as a liability, are the new Class B ROMRS also a liability?</p> <p>Paragraph .23A states that the issuer of ROMRS in a tax planning arrangement may choose to present the shares issued in that arrangement as a financial liability.”</p> <p>The choice of the word “that” indicates that the option is to be applied on a per-transaction basis, not as a policy choice or on a class-of-shares basis. In this scenario, a choice can be made for each transaction.</p>

45-65. If any of the criteria are not met, the issuer classifies the ROMRS as a financial liability. ROMRS classified as a financial liability are presented separately on the balance sheet measured at their redemption amount. Any resulting adjustment is recognized either in retained earnings or as a separate component of equity. If ROMRS are initially classified as liabilities, they cannot subsequently be reclassified as equity.


- 45-66. The following Application Insight provides a summary of the “conditions” that must be met to classify ROMRS as equity:

APPLICATION INSIGHT	
	<p>As discussed, there are three conditions that must be met for ROMRS to be classified as equity:</p> <ol style="list-style-type: none">1. Control condition – retention of control2. Consideration condition – either no consideration is received by the enterprise issuing the ROMRS or only shares of the enterprise issuing the ROMRS are exchanged in the transaction3. No redemption schedule condition – no contractual arrangement (i.e., redemption schedule) that requires the enterprise to redeem the shares at the request of the holder at a specified date or time. <p>It should be noted that the AcSB expects a relatively narrow set of circumstances should qualify ROMRS for equity classification.</p> <p>The above summary is based on the following paragraph:</p> <p>Paragraph 3856.23 <i>An enterprise that issues retractable or mandatorily redeemable shares in a tax planning arrangement may choose to present those shares at par, stated or assigned value as a separate line item in the equity section of the balance sheet only when all of the following conditions are met:</i></p> <ol style="list-style-type: none">(a) <i>control (see SUBSIDIARIES, Section 1591) of the enterprise issuing the retractable or mandatorily redeemable shares in a tax planning arrangement is retained by the shareholder receiving the shares in the arrangement;</i>(b) <i>in the arrangement, either:</i><ol style="list-style-type: none">(i) <i>no consideration is received by the enterprise issuing the retractable or mandatorily redeemable shares; or</i>(ii) <i>only shares of the enterprise issuing the retractable or mandatorily redeemable shares are exchanged; and</i>(c) <i>no other written or oral arrangement exists, such as a redemption schedule, that gives the holder of the shares the contractual right to require the enterprise to redeem the shares on a fixed or determinable date or within a fixed or determinable period.</i> <p><i>If any of the above conditions are not met for any or all of the shares issued, the issuer shall classify those shares as a financial liability, present them separately on the balance sheet and measure them in accordance with paragraph 3856.09A. Any resulting adjustment shall be recognized in either retained earnings or a separate component of equity (see EQUITY, Section 3251).</i></p>

- 45-67. The term "tax planning arrangement" is not defined in the Handbook. This term is not limited to a single transaction. A series of transactions made in contemplation of one another may also be viewed as a tax planning arrangement as indicated below:

Paragraph 3856.23D *If an enterprise issues retractable or mandatorily redeemable shares in a tax planning arrangement through a series of transactions in contemplation of one another, the transactions shall be viewed as one tax planning arrangement when assessing the conditions in paragraph 3856.23.*

- 45-68. The term "retractable or mandatorily redeemable shares" is also not defined, as it exists elsewhere in the Handbook, and it is well understood in practice. The AcSB decided that ROMRS eligible for equity treatment are not limited to preferred shares, as not all shares issued in tax planning arrangements are preferred shares.
- 45-69. The following Application Insight provides a discussion on the "series of transactions" component of the standard:


APPLICATION INSIGHT	
	<p>Paragraph .23D of Section 3856 introduces the concept of a series of transactions, and whether a series of transactions collectively makes up a tax planning arrangement.</p> <p>What should stakeholders consider when looking at this guidance?</p> <p>The guidance on the series of transactions seen as one tax planning arrangement is an area of professional judgment. It is important to consider all the facts and circumstances. For example, consider an estate freeze transaction where in step one there is an exchange of common shares for ROMRS, and in step two new common shares are subscribed for by either the same individual or someone else. In most cases, such events would be contemplated all at once; therefore, it is likely one tax planning arrangement.</p> <p>However, if the two steps occurred months apart instead of one after the other, does that time lag affect whether you decide if it is one tax planning arrangement or two? It is necessary to consider all the facts and circumstances to determine whether there was a valid reason for the time lag using professional judgment. The existence of a time lag in itself does not mean two separate tax planning arrangements exist.</p> <p>In another example, consider a scenario where the ROMRS are issued in step one and new common shares are subscribed to in step two right after. Now a year or more later, somebody else subscribes to the new common shares. In this scenario, a separate tax planning arrangement is likely if the new person was not part of the discussions when the first series of transactions were conducted.</p> <p>This area requires professional judgment and an assessment of all the facts and circumstances surrounding the transaction.</p>

- 45-70. *“Control Condition” – Control of the enterprise issuing the shares is retained by the shareholder receiving the shares.*
The control criteria for equity classification of ROMRS requires an assessment of which related party, if any, controls the enterprise. The assessment of control is performed by applying the guidance in Section 1591, SUBSIDIARIES. A party has control over the enterprise when it has the continuing power to determine its strategic operating, investing, and financing policies without the co-operation of others. This determination is based on an analysis of all facts and circumstances (see Chapter 14 of this *Guide* for further guidance on the concept of control).
- 45-71. As mentioned, the determination of whether control is retained requires an assessment of the “control condition” before and after the issuance of the ROMRS. For example, if two spouses currently own an enterprise and each receives 50% of the ROMRS issued by the enterprise, the result of the control criteria may be:
1. One individual controls the enterprise. In this case, ROMRS held by that individual may be classified as equity, and the ROMRS held by the other individual are classified as a liability.
 2. Neither spouse controls the enterprise because control is jointly held (as discussed in Section 3056, INTERESTS IN JOINT ARRANGEMENTS). In this case, all the ROMRS must be classified as a financial liability.
- 45-72. *“Consideration Condition” – No consideration other than shares.*
This condition requires that either no consideration is exchanged or that the only consideration transferred or exchanged in the transaction is shares. This requirement is based on the view that only ROMRS issued in a tax planning arrangement that do not result in a substantive change in the current or future cashflows of the enterprise should qualify for equity classification. Accordingly, transfers or exchanges that involve property and equipment (as commonly occur in an “asset rollover”) would not qualify for equity treatment. This condition criterion does allow an estate freeze effected by a stock dividend to qualify for equity classification.
- 45-73. *“No Redemption Schedule Condition”– A redemption schedule, a written or oral arrangement requiring redemption of the ROMRS within a fixed or determinable period, cannot exist.*
This results in the shares being classified as financial liabilities. The term “redemption schedule” is not defined on the grounds that such a definition would be prescriptive and lead to unintended consequences. A formal redemption schedule may be included in a shareholders’ agreement, articles of association, board or shareholders’ meeting minutes, purchase and sale agreements or elsewhere. Determination of the existence of an oral agreement will require discussion with the entity and the holder of the ROMRS. A pattern of redemptions over time may require an assessment as to whether there is an arrangement requiring redemption. ROMRS issued in an estate freeze are due on demand to receive the desired tax treatment. This feature in itself does not constitute a redemption arrangement.
- 45-74. ROMRS initially classified as equity are only reclassified as financial liabilities when certain events or transactions result in the criteria for equity classification to no longer

be met. Examples of such an event or transaction may include, but are not restricted to the following:

- death of the holder of the ROMRS
- a change in the ownership of the enterprise that affects the assessment of control of the enterprise that issued the ROMRS
- a change in the shareholders' agreement that may affect the assessment of control of the enterprise that issued the ROMRS
- redemption of some or all the ROMRS pursuant to a written or oral arrangement that gives the holder of the ROMRS the right to require the enterprise to redeem the shares within a fixed or determinable period
- creation of a written or oral arrangement that gives the holder of the ROMRS the right to require the enterprise to redeem the shares within a fixed or determinable period
- modifications to the ROMRS.

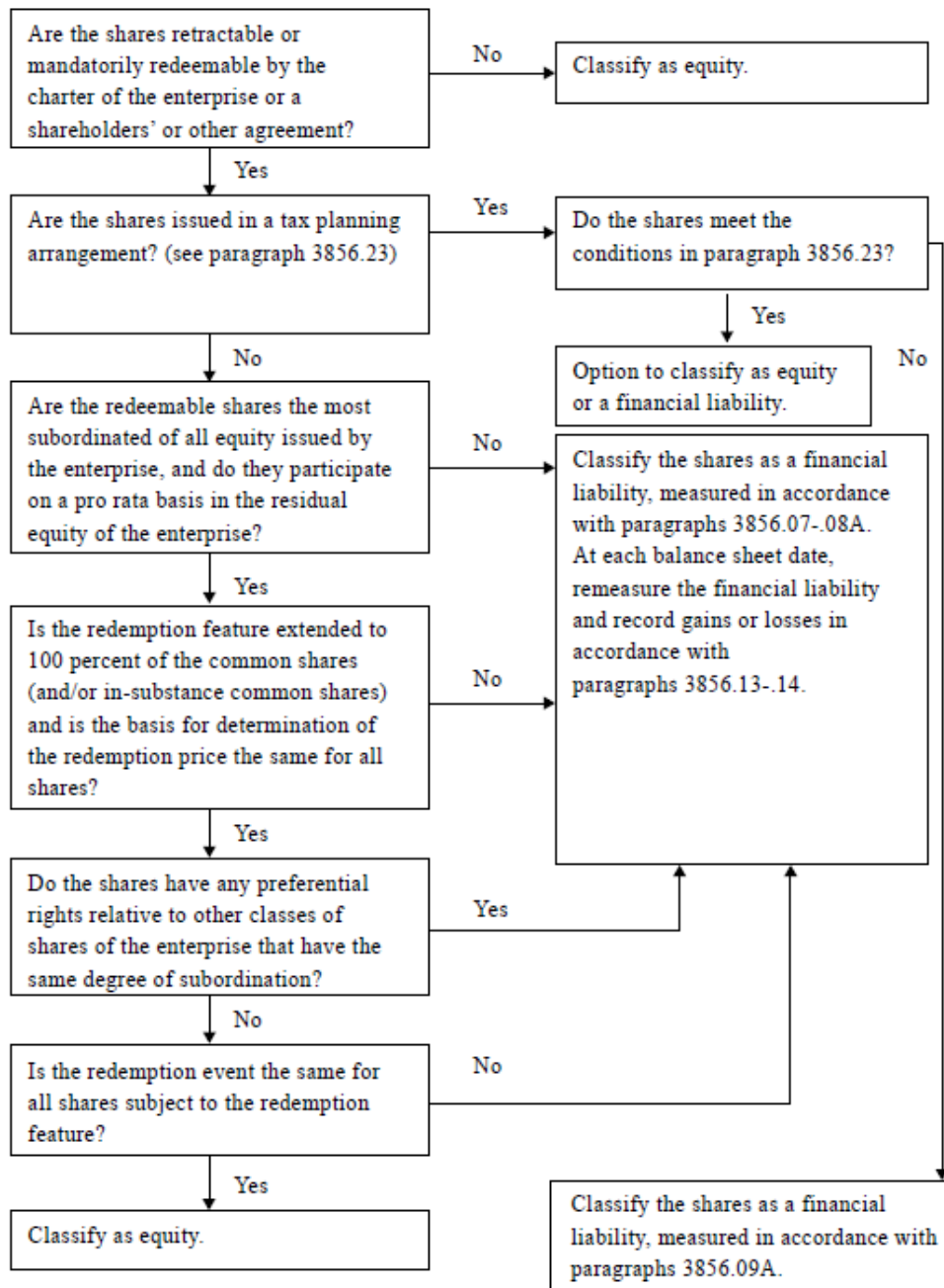
45-75. The following Application Insight provides a summary of some of the possible implications of the subsequent reclassification of ROMRS:

APPLICATION INSIGHT	
	<p>As discussed in this chapter, ROMRS initially classified as equity are only reclassified as financial liabilities when certain events or transactions result in the criteria for equity classification to no longer be met.</p> <p>The subsequent reclassification guidance can be summarized as follows:</p> <ul style="list-style-type: none"> • Initially classified as liability → equity <ul style="list-style-type: none"> • NEVER • Initially classified as equity → liability <ul style="list-style-type: none"> • Assessed if there is a “change event” and conditions are no longer met <p>The conclusion to never reclassify ROMRS initially classified as a liability is discussed in the Background Information and Basis for Conclusions, Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement, Paragraph 79:</p> <p>Paragraph 79 The Board discussed whether the reassessment criteria should only apply to shares that are classified as equity or whether it should also apply to shares classified as a financial liability. The Board decided that reassessing shares that are classified as a financial liability to determine if the shares subsequently meet the conditions for equity classification added a level of complexity in the amendments for which the costs would outweigh the benefits. As such, the Board concluded that if:</p> <ul style="list-style-type: none"> (a) the conditions for equity classification are not met on initial recognition; (b) the conditions for equity classification are not met at a


APPLICATION INSIGHT	
	<p>subsequent date (i.e., the shares are reclassified to a financial liability); or</p> <p>(c) an enterprise chooses to classify the shares as a financial liability on initial recognition,</p> <p>the enterprise is not permitted to classify the ROMRS as equity at a subsequent date.</p> <p>In the case of reclassification of ROMRS initially classified as equity, the assessment is made based on “change events”. Examples of “change events” include the following:</p> <ul style="list-style-type: none"> • death of the holder of the ROMRS • a change in the ownership of the enterprise that affects the assessment of control of the enterprise that issued the ROMRS • a change in the shareholders’ agreement that may affect the assessment of control of the enterprise that issued the ROMRS • redemption of some or all the ROMRS pursuant to a written or oral arrangement that gives the holder of the ROMRS the right to require the enterprise to redeem the shares within a fixed or determinable period • creation of a written or oral arrangement that gives the holder of the ROMRS the right to require the enterprise to redeem the shares within a fixed or determinable period • modifications to the ROMRS. <p>If there is a “change event”, an assessment is made to determine if the ROMRS still qualify for equity classification. This means that even if a change event occurs, it does not automatically trigger reclassification. For example, the shareholders’ agreement may be changed, but it is necessary to first review the change to the shareholders’ agreement and if it does not change the assessment of whether the conditions for equity classification are met, then the ROMRS can continue to be classified as equity.</p> <p>The conclusion to apply a “change event” approach for ROMRS initially classified as equity can be seen in the Background Information and Basis for Conclusions, Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement, Paragraphs 76 - 78:</p> <p>Paragraph 76 The Board considered the effect of subsequent transactions or events that may result in the criteria for equity classification no longer being met. For example, an event could occur that would result in control no longer being retained by the holder of the ROMRS. The Board decided to create reassessment criteria that:</p> <p>(a) would not require a continuous assessment by financial statement preparers; and</p>

APPLICATION INSIGHT	
	<p>(b) would be on the same basis as the criteria for the classification exception on initial recognition.</p> <p>Paragraph 77 The amendments require that an enterprise should reassess the equity classification of the ROMRS if a transaction or event occurs that could indicate that one of the conditions for equity classification may no longer be met. Examples of transactions or events that might give rise to the need to reassess equity classification are provided in the standard to assist stakeholders in understanding circumstances that may require reassessment.</p> <p>Paragraph 78 Reassessment would not automatically lead to reclassification of ROMRS from equity to liability. The transaction or event would require financial statement preparers to reassess whether the conditions for equity classification continue to be met or whether reclassification of the shares is required.</p>

- 45-76. If ROMRS initially classified as equity are subsequently reclassified as a financial liability, the shares are measured at their redemption amount on the date the event or transaction occurs that necessitates such reclassification. The ROMRS are presented separately as a financial liability on the balance sheet along with any resulting adjustment being recorded in retained earnings or a separate component of equity. The subsequent reclassification of ROMRS is discussed later in this chapter.
- 45-77. The following decision tree outlines the initial classification of ROMRS:


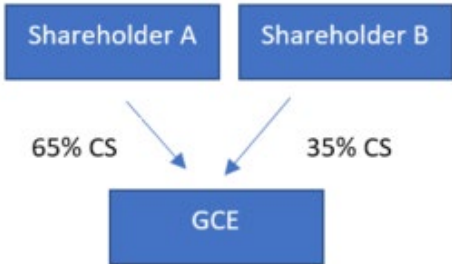


45-78. The following Application Example demonstrates the liability vs. equity classification of ROMRS:

APPLICATION EXAMPLE	
	<p>Scenario A demonstrates the result of failure to meet the criteria in paragraph 3856.23 (i.e., liability treatment). Scenario B demonstrates the result of meeting the criteria (i.e., equity treatment).</p> <p>In both scenarios, assume the ROMRS have a stated amount of \$1,000 and redemption amount of \$2 million.</p>

APPLICATION EXAMPLE			
		Scenario A	Scenario B
	Assets		
	Cash	\$150,000	\$150,000
	Investments	200,000	200,000
	Accounts receivable	<u>100,000</u>	<u>100,000</u>
	Total assets	\$450,000	\$450,000
	Liabilities		
	Accounts payable	\$100,000	\$100,000
	ROMRS	<u>2,000,000</u>	<u>-</u>
		\$2,100,000	\$100,000
	Shareholders' equity		
	Common shares	10,000	10,000
	ROMRS	-	1,000
	Retained earnings/(deficit)	<u>(1,660,000)</u>	<u>339,000</u>
	Total liabilities and shareholders' equity	\$450,000	\$450,000

45-79. The following Application Example illustrates the control condition in paragraph 3856.23(a):

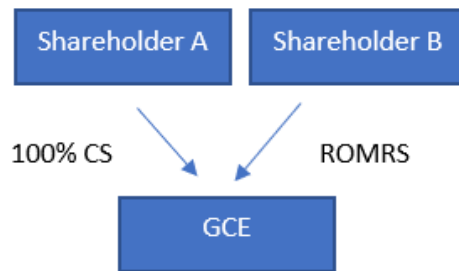
APPLICATION EXAMPLE	
	<p>GCE Enterprises has two shareholders: Shareholder A owns 65% of the common shares and Shareholder B owns the remaining 35% of the common shares.</p> <p style="text-align: center;">Before</p> <div style="text-align: center;">  <pre> graph TD SA[Shareholder A] -- 65% CS --> GCE[GCE] SB[Shareholder B] -- 35% CS --> GCE </pre> </div> <p style="text-align: center;">CS – Common Stock</p>

APPLICATION EXAMPLE

Scenario A – Estate Freeze by Shareholder B

An estate freeze transaction was performed by Shareholder B, whereby the common shares of Shareholder B were exchanged for ROMRS. Shareholder A did not undertake any such transaction and, accordingly, now owns 100% of the common shares. Prior to the transaction, it was assessed that Shareholder A controlled GCE Enterprises (i.e., Shareholder A had the continuing power to determine GCE's strategic operating, investing and financing policies).

After



CS – Common Stock

Application of the control condition (3856.23(a)) would result in the ROMRS being treated as a liability by GCE. Because Shareholder B did not have control over GCE prior to the estate freeze, Shareholder B cannot “retain” control.

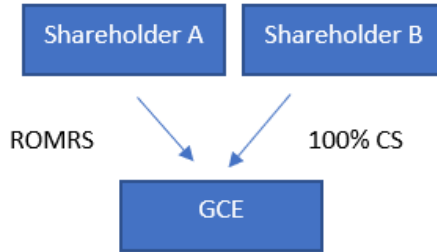
Conclusion: ROMRS are recoded as a liability.

Scenario B – Estate Freeze by Shareholder A

Using the same facts as above but with the amendment that Shareholder A undertook the estate freeze, Shareholder B now holds 100% of the common shares after the tax planning arrangement. However, rights are provided to Shareholder A such that Shareholder A retains control.

APPLICATION EXAMPLE

After



CS – Common Stock

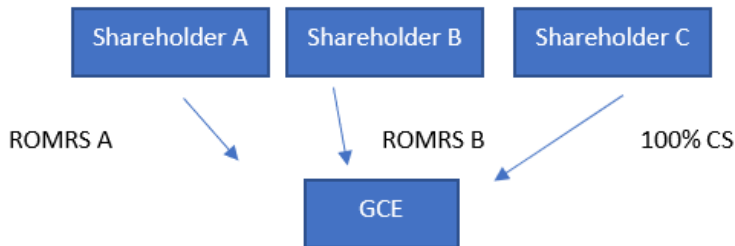
Application of the control condition (3856.23(a)) would result in the ROMRS being eligible to be classified as equity by GCE if Shareholder A continues to control GCE through substantive rights or other factors as set out in Section 1591 (i.e., if the ROMRS had sufficient voting rights to have more votes than those held by Shareholder B). That is, Shareholder A controlled GCE before *and* after the issuance of the ROMRS in the estate freeze.

Conclusion: ROMRS may be recorded as equity (at par, stated or assigned value as a separate line item in the equity section). (ROMRS may also be recorded as a financial liability at the redemption amount, if such option is chosen.)

Scenario C – Estate Freeze by both Shareholder A and B

Using the same facts as above, with the amendment that both Shareholder A and B undertook an estate freeze, and that a new Shareholder C now holds 100% of the common shares of GCE after the estate freeze.

After



CS – Common Stock

APPLICATION EXAMPLE

Application of the control condition per 3856.23(a) would result in the ROMRS issued to Shareholder A to be classified as equity if Shareholder A had, and continues to have control, and the ROMRS issued to Shareholder B being classified as a liability. (The ROMRS issued to Shareholder A could also be classified as a financial liability at the redemption amount, if such option is chosen.)

45-80. The following Application Example also illustrates the application of the control condition, using an indirect ownership scenario:

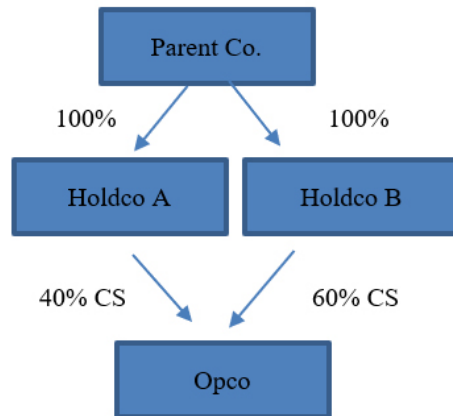
APPLICATION EXAMPLE



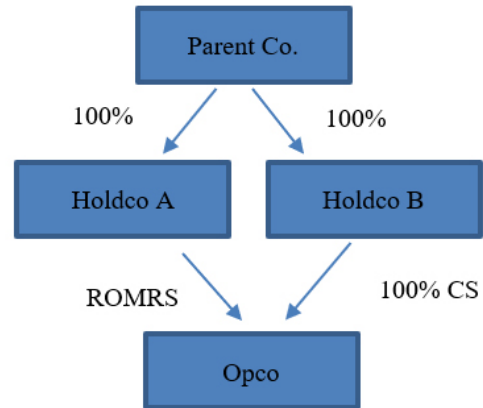
Facts and assumptions:

- Parent Co. owns 100% of Holdco A and Holdco B
- Holdco A has a 40% interest in Opco and Holdco B has a 60% interest in Opco
- Holdco A engages in an estate freeze transaction and exchanges its 40% common share interest in Opco for ROMRS
- Assume that new voting shares for the 40% interest are issued to Holdco B which now holds 100% of the votes in Opco
- The question is, do the ROMRS issued by the Opco to Holdco A meet the control condition for equity classification?

Before



After



Factors to consider:


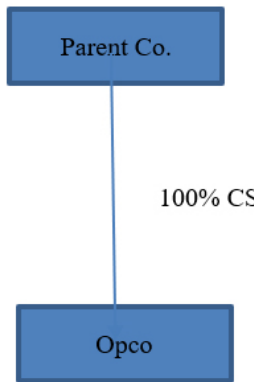
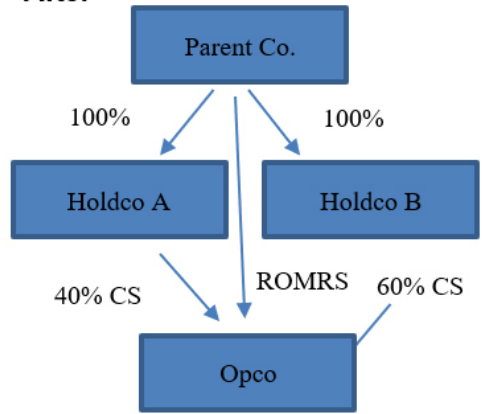
If the transaction is looked at from the perspective of Holdco A, it only has 40% ownership of Opco. Therefore, it does not control Opco before or after the estate freeze transaction.

However, from the perspective of Parent Co., nothing of substance has changed because Parent Co. still indirectly controls 100% of both Holdco's and, by extension, Opco.

The guidance on control in Section 1591, *Subsidiaries* indicates that you would look through Holdco A to Parent Co. and determine that control of Opco is indirectly held by Parent Co. It is acceptable to consider indirect control if nothing of substance has changed from the ultimate Parent Co's perspective. However, the second half of the control condition states that


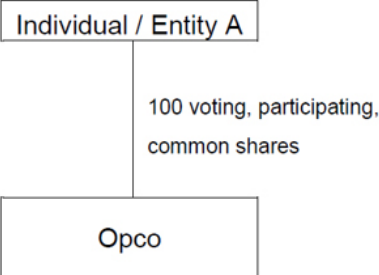
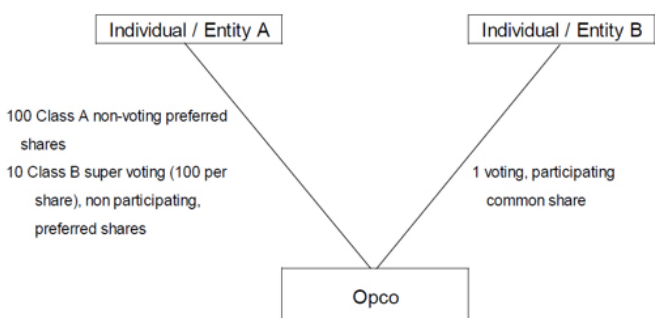
APPLICATION EXAMPLE	
	<p>control “is retained by the shareholder receiving the shares”. The question becomes, who is receiving the ROMRS: Holdco A (which has a minority interest in Opco) or Parent Co.?</p> <p>It is important to use professional judgment, given all the facts and circumstances. There is a strong case to be made that nothing of substance has changed particularly from the perspective of Parent Co. It could also be said that Parent Co. indirectly holds the ROMRS. At the same time, there is also a strong case to be made that the shares are not held by the Parent Co., which has control of Opco. Again, the use of professional judgment is required to form the appropriate conclusion.</p>

45-81. The following Application Example illustrates the application of the control condition that may arise on transition based on a pre-existing situation:

APPLICATION EXAMPLE	
	<div style="display: flex; justify-content: space-around;"> <div style="text-align: center;"> <p>Before</p>  </div> <div style="text-align: center;"> <p>After</p>  </div> </div> <p>This set of circumstances is similar to the previous Application Example, but initially Parent Co. held all the voting shares in Opco and there were no holding companies. The following facts and assumptions are relevant to the scenarios above:</p> <ul style="list-style-type: none"> • After a few tax planning arrangements, Parent Co. now holds ROMRS in Opco, but its ownership interest in Opco is held through Holdco A and Holdco B. • From a control perspective, control of Opco is indirectly held by Parent Co., which may be appropriate to consider in the context of Section 1591. • The ROMRs are held by Parent Co., which is the entity that controls Opco before and after the tax planning arrangement. <p>Should the ROMRS issued by Opco be classified as equity or liability when the amendments to Section 3856 are adopted, assuming the ROMRS were issued prior to January 1, 2018?</p> <p>When looking at the control condition, judgment needs to be applied. It is important to consider all the facts and circumstances of the tax planning arrangement before reaching a conclusion as to whether the control condition is met or not.</p>


APPLICATION EXAMPLE	
	<p>It is important to note that that the control condition on transition requires control be “held” by the shareholder holding the shares, which is different than the control condition applied when the transaction is assessed subsequent to transition, which looks at whether control is retained.</p> <p>Details on adoption of the new guidance is discussed later in this chapter. However, generally speaking, an enterprise may choose to apply the ROMRS amendments retrospectively or at the beginning of the adoption year. In this case, if the ROMRS were issued prior to January 1, 2018, and both the redemption condition and control of Opco is held by Parent Co., then the shares can be treated as equity. (The ROMRS can also be classified as a financial liability, if desired.)</p>

45-82. The following Application Example illustrates the application of the second condition (i.e., no consideration) to assess whether ROMRS issued in a tax planning arrangement can be classified as equity:

APPLICATION EXAMPLE	
	<p>The second condition for equity classification of ROMRS in paragraph 23(b) of Section 3856 is that either no consideration is received by the enterprise issuing the ROMRS or only shares of the enterprise issuing the ROMRS are exchanged in the transaction.</p> <p>That is, if there is cash or other assets involved or if liabilities are assumed in the tax planning arrangement, it is implied that something of substance has changed for the enterprise issuing the ROMRS. ROMRS in those circumstances are classified as a liability.</p> <p>The question is whether the inclusion of a small amount of cash to make a tax planning arrangement effective still meets this condition or not. The following scenario is provided to illustrate the use of professional judgment in such a case:</p> <div style="display: flex; justify-content: space-around;"> <div style="text-align: center;"> <p>Before:</p>  </div> <div style="text-align: center;"> <p>After:</p>  </div> </div> <p>In step one of the estate freeze, 100 voting, participating, common shares are exchanged for 100 Class A non-voting preferred shares by Entity A.</p> <p>In step two, Entity A subscribes for 10 Class B super voting shares for \$10 and Entity B subscribes for one voting, participating common share for \$1.</p>

APPLICATION EXAMPLE	
	<p>In this scenario, the steps collectively form the tax planning arrangement. Entity A retains control with the super voting shares. This may seem straight forward, but to legally affect this estate freeze, Entity A and Entity B both have received voting shares in exchange for some consideration, which may include cash.</p> <p>The question is, does the nominal amount paid for those shares break the no consideration condition?</p> <p>When cash or assets are included in a transaction or liabilities are assumed, something has changed because there has been an exchange of consideration. However, paying nominal consideration (i.e., \$1 or \$10) to purchase the super voting shares is non-substantive to the transaction and is completed only to legally affect the transaction.</p> <p>Therefore, in this scenario, using professional judgment, the condition is met. However, if the amount was not nominal, or the consideration for the voting shares included some other assets in the transaction that were meaningful, then using professional judgment, it would seem that the consideration is substantive to the transaction and has an effect on the issuer. In that case, this condition is not met, and the ROMRS are classified as a liability.</p> <p>In some transactions, the cash consideration is not for the ROMRS but rather for the new common shares. Since the cash is not for the ROMRS, is it correct to conclude this condition is met?</p> <p>From the AcSB's perspective, it is not so much about the consideration being for the ROMRS specifically, but rather it is about the consideration being part of the transaction itself.</p> <p>When more than a very minimal amount of cash for legal purposes is involved or if other assets are involved in a tax planning arrangement, something of substance is changing for the issuer of the ROMRS. In this situation, the ROMRS should be classified as a liability.</p>

- 45-83. The following Application Example illustrates the application of the third condition to assess whether ROMRS can be classified as equity:


APPLICATION EXAMPLE	
	<p>Paragraph .23(c) of Section 3856 states that if there is a contractual arrangement, such as a redemption schedule that requires the enterprise to redeem the shares at the request of the holder at a specified date or time, the shares are a liability. One question that has been asked is what if there is a redemption schedule for some of the ROMRS, but not all?</p> <p>For example, assume an enterprise issued 1,000 ROMRS in year one. In year two, a redemption schedule is drawn up for 100 of those shares. The question may be, does that taint the remaining 900 shares for which there is no redemption schedule?</p> <p>Paragraph 3856.23, states: "If any of the above conditions are not met for any or all of the shares issued, the issuer shall classify those shares as a financial liability".</p>

APPLICATION EXAMPLE	
	<p>Since it indicates that only those shares for which there is a redemption schedule should be classified as a liability, in this scenario where there are 1,000 ROMRS issued and only 100 have a redemption schedule, only the 100 shares are classified as a liability and the remaining 900 shares are equity (assuming the other two conditions are also met).</p> <p>In a second similar scenario, assume in year one there is a redemption schedule for 100 shares and then in year three, there is another redemption schedule for 100 shares and again in year five. Now there is a pattern of redemptions. Professional judgment must be applied and it is possible to conclude that all the shares at this point should also be classified as a liability, not just the 100 shares for each time in which there is a redemption schedule.</p>

Tax accounting implications - ROMRS

- 45-84. When ROMRS are remeasured from a nominal amount within equity to the redemption amount as a financial liability and an enterprise applies the future income taxes method, it may necessary to adjust for the effects.

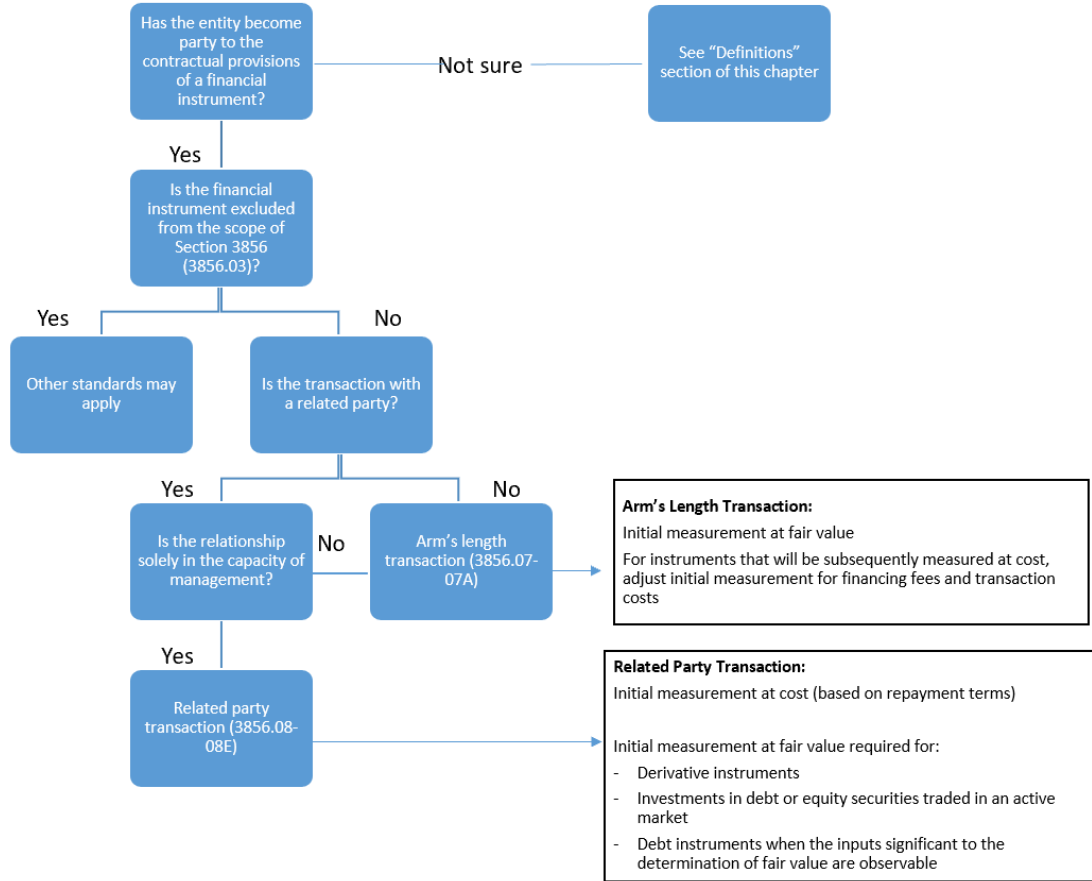
- 45-85. The following Application Insight highlights some of the possible implications resulting from a reclassification of ROMRS if the future income tax method is followed:

APPLICATION INSIGHT	
	<p>ROMRS issued in a tax planning arrangement are generally not quoted in an active market and do not have inputs that are significant to the determination of their fair value that are observable.</p> <p>Illustrative Example 4 in Section 3840, RELATED PARTY TRANSACTIONS, provides an example where a sale of a building is completed with a related party using a Section 85 rollover election, which results in the issuance of ROMRS. The transaction is looked at from the viewpoint of the seller and purchaser of the building, measurement is assessed at the carrying amount and exchange amount and it is assumed the future income taxes method is applied.</p> <p>The example illustrates that it is necessary to consider the recording of future income taxes as a result of the difference between the tax basis of the shares received, normally nominal, and the amount of the shares for financial statement purposes. However, professional judgement is needed. For example, if the buyer is a subsidiary of the seller, and it is apparent that the temporary difference will not reverse in the foreseeable future, the future income tax liability would not be recoded by the seller.</p> <p>(See Chapter 35 of this <i>Guide</i> for guidance on accounting for future income taxes and Chapter 42 of this <i>Guide</i> for guidance on the accounting for related party transactions.)</p>

Summary of initial measurement

45-86. The following chart illustrates the initial measurement of financial instrument transactions (excluding ROMRS) in accordance with Section 3856:

Initial Measurement (excluding ROMRS)



45-87. The following chart also summarizes **initial measurement** of financial instruments in a chart format. It includes all financial instruments and is modified from the chart included in paragraph 3856.A7A:

Instrument	Originated or acquired or issued or assumed in an arm's length or related party transaction	Initial measurement
Investments in equity instruments quoted in an active market	arm's length transaction	Fair value in accordance with paragraph 3856.07
	related party transaction	Fair value in accordance with paragraph 3856.08C(a)
	arm's length transaction	Fair value in accordance with paragraph 3856.07

Instrument	Originated or acquired or issued or assumed in an arm's length or related party transaction	Initial measurement
Investments in equity instruments not quoted in an active market	related party transaction	Cost in accordance with paragraph 3856.08A
Derivatives	arm's length transaction	Fair value in accordance with paragraph 3856.07
	related party transaction	Fair value in accordance with paragraph 3856.08C(d)
Debt instruments quoted in an active market	arm's length transaction	Fair value in accordance with paragraph 3856.07
	related party transaction	Fair value in accordance with paragraph 3856.08C(b)
Debt instruments when the inputs significant to the determination of the fair value of the instrument are observable, either directly or indirectly	arm's length transaction	Fair value in accordance with paragraph 3856.07
	related party transaction	Fair value in accordance with paragraph 3856.08C(c)
Debt instruments not quoted in an active market and for which inputs significant to the determination of the fair value of the instrument are not observable	arm's length transaction	Fair value in accordance with paragraph 3856.07
	related party transaction	Cost in accordance with paragraph 3856.08(a)
ROMRS issued in a tax planning arrangement that are classified as a financial liability	arm's length transaction	Redemption amount in accordance with paragraph 3856.09A
	related party transaction	Redemption amount in accordance with paragraph 3856.09A
Other financial instruments	arm's length transaction	Fair value in accordance with paragraph 3856.07
	related party transaction	Cost in accordance with paragraph 3856.08(a)

Subsequent Measurement

- 45-88. With some exceptions, financial instruments are subsequently measured based on how an enterprise initially measured them. The following chart has been replicated from the Handbook and provides guidance on initial and subsequent measurement of financial instruments:

Instrument	Initial measurement	Subsequent measurement
Retractable or mandatorily redeemable shares issued in a tax planning arrangement that are classified as a liability	Redemption amount in accordance with 3856.09A	Redemption amount in accordance with 3856.15A
Investments in equity instruments quoted in an active market	Fair value in accordance with paragraphs 3856.07 or 3856.08C(a)	Fair value in accordance with paragraph 3856.12(a)
Investments in equity instruments not quoted in an active market	Fair value in accordance with paragraph 3856.07	Cost or fair value in accordance with paragraphs 3856.11(a)(iii) or 3856.13
	Cost in accordance with paragraph 3856.08A	Cost method in accordance with paragraph 3856.11(b)
Derivatives	Fair value in accordance with paragraphs 3856.07 or 3856.08C(d)	Fair value in accordance with paragraph 3856.12(b)
Debt instruments quoted in an active market	Fair value in accordance with paragraphs 3856.07 or 3856.08C(b)	Amortized cost in accordance with paragraphs 3856.11(a)(iv)-(v); or fair value in accordance with paragraphs 3856.13(a) or 3856.13A(a)
Debt instruments when the inputs significant to the determination of the fair value of the instrument are observable, either directly or indirectly	Fair value in accordance with paragraphs 3856.07 or 3856.08C(c)	Amortized cost in accordance with paragraph 3856.11(a); or fair value in accordance with paragraphs 3856.13(a) or 3856.13A(b)
Debt instruments not quoted in an active market and for which inputs significant to the determination of the fair value of the instrument are not observable	Fair value in accordance with paragraph 3856.07	Amortized cost or fair value in accordance with paragraphs 3856.11(a)(iv)-(v) or 3856.13(a)
	Cost in accordance with paragraph 3856.08(a)	Cost method in accordance with paragraph 3856.11(b)

- 45-89. If an enterprise initially measured a financial instrument at fair value, it subsequently measures the instrument as follows:
- Investments in equity instruments quoted in an active market and derivative instruments are subsequently measured at fair value.
 - Investments in equity instruments resulting from arm's length transactions that are not quoted in an active market are subsequently measured at cost less any impairment adjustment.
 - All other financial assets and financial liabilities are measured at amortized cost.

It should be noted that an enterprise may elect to subsequently measure any financial asset originated/ acquired or any financial liability issued/ assumed (except ROMRS) in an arm's length transaction at fair value by designating that fair value measurement applies. Changes in fair value are recognized in net income.


- 45-90. Derivative instruments designated in a qualifying hedging relationship, or linked to and must be settled by delivery of equity instruments of another enterprise whose fair value cannot be readily determined, are not required to be subsequently measured at fair value.
- 45-91. If an enterprise initially measured a financial instrument at cost, it subsequently measures the instrument using the cost method less any impairment adjustment.

Indexed financial liabilities

- 45-92. The issuer of a financial liability indexed to a measure of the enterprise's financial performance or to changes in the value of the enterprise's equity accounts for the instrument as follows:
- Initial measurement of the liability is measured in accordance with paragraph 3856.07 or 3856.08, including the related exceptions, depending on whether the instrument is a related party financial liability or not.
 - Interest expense is calculated using the stated rate adjusted for amortization of any premium or discount.
 - For indexed financial liabilities which are not related party financial liabilities, subsequent measurement is at the higher of (i) the amortized cost of the debt or (ii) the amount that would be due at the balance sheet date if the formula determining the additional amount were to be applied at that date.
 - For related party financial liabilities, subsequent measurement is at the higher of (i) the cost of the debt or (ii) the amount that would be due at the balance sheet date if the formula determining the additional amount were to be applied at that date.
- 45-93. Section 3856 requires readers of an entity's financial statements to be alerted to any terms of a liability that might cause unusual future cash flows. When a liability is indexed to a measure of the entity's performance, it must be measured using an estimate of the intrinsic value of the indexing feature at the reporting date. Examples of indexing features are payments based on actual or average net income or earnings before interest, taxes, depreciation and amortization (EBITDA), increase in net

income or EBITDA above a specified baseline and increase in share price or value above a specified baseline. Any amount recognized at a reporting date as an additional amount payable is reported as a separate component of interest expense. If at a subsequent reporting date, the additional payment is no longer required, the carrying amount of the liability is revised and the adjustment is recognized as a deduction from interest expense.

- 45-94. In applying a formula that measures a payment based on performance over several periods (some of which haven't occurred), the formula is computed as if it is applied only to periods ending within the reporting date (illustrated by the entries below):

APPLICATION EXAMPLE				
	On July 1, 20X1, Private Corp. issues a \$100,000 five-year note to an unrelated party bearing interest at 8% plus 10% of the entity's average EBITDA for the five years ending June 30, 20X6.			
	Date	Entries required	Reported balances	
	July 1, 20X1	Dr. Cash \$100,000 Cr. Notes payable \$100,000	Note payable	\$100,000
	June 30, 20X2	Dr. Interest expense \$13,300 (8,000 + 5,300) Cr. Cash \$8,000 (8% * \$100,000) Cr. Note payable 5,300 (10% * \$53,000)	EBITDA Note payable	\$53,000 105,300
	June 30, 20X3	Dr. Interest expense \$2,700 (8,000 – 5,300) Dr. Note payable 5,300 Cr. Cash \$8,000 (8% * \$100,000)	EBITDA (loss) Note payable	\$(65,000) 100,000
	June 30, 20X4	Dr. Interest expense \$9,200 (8,000 + 1,200) Cr. Cash \$8,000 (8% * \$100,000) Cr. Note payable \$1,200	EBITDA Note payable	\$48,000 101,200
	June 30, 20X5	Dr. Interest expense \$9,800 (8,000 + 1,800) Cr. Cash \$8,000 (8% * \$100,000) Cr. Note payable 1,800	EBITDA Note payable	\$84,000 103,000
	June 30, 20X6	Dr. Interest expense \$9,500 (8,000 + 1,500) Cr. Cash \$8,000 (8% * \$100,000) Cr. Note payable 1,500	EBITDA Note payable	\$105,000 104,500

APPLICATION EXAMPLE	
	<p>Check: Average EBITDA = $(\\$53,000 - \\$65,000 + \\$48,000 + \\$84,000 + \\$105,000)/5 = \\$45,000$. 10% of average EBITDA = \$4,500, which equals the total increase in the note payable over five years.</p>

Cost / amortized cost


45-95. Amortized cost is defined in paragraph 3856.05(a) as follows:

Paragraph 3856.05(a) Amortized cost is the amount at which a financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment (see paragraphs 3856.A3-.A6).


45-96. The term "cost" is not specifically defined in Section 3856. A layman's definition describes cost as the amount paid to acquire the financial instrument. This is consistent with the definition of historical cost provided in paragraph 1000.48. The cost method is defined in Appendix A of this document as follows:

The **cost method** is a basis of accounting for financial instruments whereby the instrument is initially recorded at cost; earnings from such instruments are recognized only to the extent received or receivable.

45-97. The following Application Example illustrates the subsequent measurement of shares held in a private enterprise (i.e., shares not quoted in an active market):


APPLICATION EXAMPLE					
	<p>On February 14, 20X1, Investor Corp. invests \$10,000 in 10,000 common shares of Private Corp., to give Investor Corp. a 10% voting interest in the company. Investor Corp. and Private Corp. are unrelated. The price paid for the acquisition of the common shares represents the fair value of the shares at the purchase date.</p> <p>By December 31, 20X1, (Investor Corp.'s year end) the fair value of this investment has increased to \$12,500.</p> <table border="0" style="width: 100%;"> <thead> <tr> <th style="text-align: left;">Date</th> <th style="text-align: left;">Entry</th> </tr> </thead> <tbody> <tr> <td>December 31, 20X1</td> <td>No entry because the investment is not quoted on an active market and is therefore classified by Investor Corp. to be measured at cost. No adjustment is required for the change in fair value. (Assuming Investor Corp. did not make the irrevocable election under paragraph 3856.13 to subsequently measure the common shares of Private Corp. at fair value.)</td> </tr> </tbody> </table>	Date	Entry	December 31, 20X1	No entry because the investment is not quoted on an active market and is therefore classified by Investor Corp. to be measured at cost. No adjustment is required for the change in fair value. (Assuming Investor Corp. did not make the irrevocable election under paragraph 3856.13 to subsequently measure the common shares of Private Corp. at fair value.)
Date	Entry				
December 31, 20X1	No entry because the investment is not quoted on an active market and is therefore classified by Investor Corp. to be measured at cost. No adjustment is required for the change in fair value. (Assuming Investor Corp. did not make the irrevocable election under paragraph 3856.13 to subsequently measure the common shares of Private Corp. at fair value.)				

- 45-98. The following Application Example illustrates the accounting for an interest-bearing investment in Guaranteed Investment Certificates (GICs) subsequently measured at amortized cost:


APPLICATION EXAMPLE																
	<p>On February 14, 20X1, Investor Corp. invests, through an unrelated financial institution, \$10,000 in a 30-month Bank of Prosperity non-redeemable GIC that guarantees a return of 2.40%. Investor Corp. did not pay any fees or transaction costs associated with this investment. At December 31, 20X1, the interest rate on similar GICs decreased to 2.05%, thereby increasing the fair value of the GIC held by Investor Corp. by year end.</p> <p>Assuming Investor Corp. uses amortized cost as the basis for subsequent measurement, it would record the following entries throughout the 20X1 year:</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Dr. Investment in GIC</td> <td style="width: 20%; text-align: right;">\$10,000</td> <td style="width: 20%;"></td> </tr> <tr> <td style="padding-left: 20px;">Cr. Cash</td> <td></td> <td style="text-align: right;">\$10,000</td> </tr> <tr> <td> </td> <td></td> <td></td> </tr> <tr> <td>Dr. Interest receivable</td> <td style="text-align: right;">\$210</td> <td></td> </tr> <tr> <td style="padding-left: 20px;">Cr. Interest income</td> <td></td> <td style="text-align: right;">\$210</td> </tr> </table> <p>(10.5 months/12 months*2.4%*\$10,000)</p> <p>The increase in fair value of the investment is ignored because the investment is measured at amortized cost. (Assuming Investor Corp. did not make the irrevocable election under paragraph 3856.13 to subsequently measure the GIC at fair value.)</p>	Dr. Investment in GIC	\$10,000		Cr. Cash		\$10,000	 			Dr. Interest receivable	\$210		Cr. Interest income		\$210
Dr. Investment in GIC	\$10,000															
Cr. Cash		\$10,000														
Dr. Interest receivable	\$210															
Cr. Interest income		\$210														

Amortization of initial purchase premium or discount, financing fees and transaction costs

- 45-99. Any systematic amortization of purchase premiums/discounts, fees and/or costs to net income may be used. The effective interest method is theoretically preferred, but Section 3856 permits the use of alternative methods (e.g., the straight-line method). In many situations, the difference between the effective interest method and straight-line amortization will not be material.
- 45-100. The following Application Example demonstrates the accounting for a purchase discount on a treasury bill:

APPLICATION EXAMPLE							
	<p>On January 1, 20X1, Investor Corp. decides to invest in a one-year \$10,000 Government of Canada treasury bill to yield 1.45%.</p>						
	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Principal amount of T-bill</td> <td style="text-align: right;">\$10,000</td> </tr> <tr> <td>Initial investment (PV of \$10,000, $n = 1$, $i = 1.45\%$)</td> <td style="text-align: right;">\$9,857</td> </tr> <tr> <td>Interest income recognized over the year</td> <td style="text-align: right;">\$143</td> </tr> </table>	Principal amount of T-bill	\$10,000	Initial investment (PV of \$10,000, $n = 1$, $i = 1.45\%$)	\$9,857	Interest income recognized over the year	\$143
	Principal amount of T-bill	\$10,000					
	Initial investment (PV of \$10,000, $n = 1$, $i = 1.45\%$)	\$9,857					
Interest income recognized over the year	\$143						
<p>For interim reporting purposes, the interest may be recognized using any systematic and rational method, including straight-line amortization. Interest $(\\$10,000 - \\$9,857)/12$ is approximately \$12 per month. (Assuming Investor Corp. did not make the irrevocable election under paragraph 3856.13 to subsequently measure the Canada treasury bill at fair value.)</p>							

45-101. The following Application Example demonstrates the accounting for a loan at a non-market rate of interest over multiple periods of time:

APPLICATION EXAMPLE	
	<p>Seller Corporation finances Customer Co.'s (an unrelated party) purchase of a \$1,000 machine by extending payment for three years. Interest is payable annually at 3%. The market rate of interest for a similar loan to an entity with Customer Co.'s credit rating is 5%. The loan is initially measured at its fair value of \$946 (net present value of \$30 of interest for three years and principal repayment of \$1,000, both discounted at 5%).</p>
	<p>The net amount of the loan of \$946 accretes to \$1,000 over its three-year term. The accretion can be determined using any systematic method, including the effective interest method at 5% or the straight-line method. From Seller Corporation's perspective, it should be shown in net income as part of interest income as a separate line on the income statement or in the notes to the financial statements. From Customer Co.'s perspective, it will be interest expense.</p> <p>The following schedule shows the calculations for the journal entries using the effective interest method:</p>

APPLICATION EXAMPLE					
	Effective interest method	Total interest: 5% per annum	Cash interest received / receivable	Accretion of discount (cash interest + accretion = total interest)	Loan receivable balance – end of period
					\$946
February 14 20X1					\$946
20X1 (10.5 months)		$(10.5/12)*5%*\$946 = \41	$(10.5/12)*\$30 = \26	$\$41 - \$26 = \$15$	$\$946 + \$15 = \$961$
20X2		$5%*\$961 = \48	\$30	$\$48 - \$30 = \$18$	$\$961 + \$18 = \$979$
20X3		$5%*\$979 = \49	\$30	$\$49 - \$30 = \$19$	$\$979 + \$19 = \$998$
20X4 (1.5 months)		$(1.5/12)*5%*\$998 = \6	$(1.5/12)*\$30 = \4	$\$6 - \$4 = \$2$	$\$998 + \$2 = \$1000$
Total		\$144	\$90	\$54	
<i>December 31, 20X1</i>					
	Dr. Interest receivable	\$26			
	Cr. Interest income		\$26		
To record the cash interest receivable					
	Dr. Loan receivable	\$15			
	Cr. Interest income		\$15		
To record the accretion of the discount					
<i>December 31, 20X2</i>					
	Dr. Cash	\$30			
	Cr. Interest income		\$30		
To record the cash interest receivable					
	Dr. Loan receivable	\$18			
	Cr. Interest income		\$18		
To record the accretion of the discount					

APPLICATION EXAMPLE	
	Journal entries for 20X3 and 20X4 will be similar and are therefore not provided. (Assuming that Seller Corporation did not make the irrevocable election under paragraph 3856.13 to subsequently measure the loan receivable at fair value.)

Interest, dividends, losses and gains

- 45-102. The classification of a financial 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. This means that dividend distributions on financial instruments of the issuer classified as equity are treated as dividends and reported directly in equity (as opposed to interest expense reported in the income statement associated with a financial instrument classified as a liability). The requirement is as follows:

Paragraph 3856.15 *An enterprise shall report interest, dividends, losses and gains relating to a 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.)*

- 45-103. Gains and losses associated with redemptions or re-financings of instruments classified as liabilities are reported in net income, while redemptions or re-financings of instruments classified as equity are reported as changes in equity.
- 45-104. Dividend distributions classified as an expense may be presented in the income statement either with interest on other liabilities or as a separate line item. Disclosure of interest and dividends is subject to the requirements of INCOME STATEMENT, Section 1520 (see Chapter 10 of this *Guide*).
- 45-105. Due to the significant tax treatment differences between interest and dividends, it may be desirable to disclose dividend distributions classified as expense separately within the income statement. In addition, disclosures of the associated tax effects are made in accordance with INCOME TAXES, Section 3465 (see Chapter 35 of this *Guide*).

Impairment

Overview

- 45-106. Financial assets measured at cost/amortized cost or using the cost method are assessed for impairment each reporting period. Financial assets measured at fair value are not assessed for impairment since they are remeasured each reporting period. A summary of the accounting for impairments is as follows:

- The first step is to assess whether there are any indicators of impairment. If indicators of impairment exist, then an impairment calculation is completed.
- The financial asset is written down to the amount expected to be recovered. This is determined in slightly different ways depending on whether the financial asset was originated or acquired in a related party transaction or not.
- An impairment can be recorded as a reduction of the carrying amount of the financial asset or through an allowance account.
- An impairment is reversed in future periods if the amount expected to be recovered increases.

Assessment of individual assets or a group of assets for impairment

- 45-107. Financial assets measured at cost/ amortized cost or using the cost method are assessed for impairment individually when they are individually significant. Investments in equity securities are assessed individually.
- 45-108. Financial assets may be assessed for impairment on a group basis when they are affected by the same factors. For example, 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 on 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 (e.g., uncompensated payment delays). To ensure that the loss ratios applied reflect the most current information available, the formulae must be reviewed regularly.
- 45-109. For other groups of assets that share identifiable common characteristics (e.g., loans), information available at the date of preparation of the financial statements may not be adequate to identify each individual impaired loan and the full extent of impairment within the group as a whole. In such cases, the extent of additional impairment is estimated collectively based on the enterprise's judgment of the impact on the group of assets of recent events and changes in economic conditions that indicate the existence of impairment. In making such judgments, consideration is given to the effect on loss experience of similar events and changes in conditions in the past. Measurement of the extent of the additional impairment present in a group of assets is based on an assessment of the extent to which future cash flows are expected to be reduced or delayed.

Indicators of impairment

- 45-110. Financial assets are only required to be assessed for impairment if there are indicators of impairment. In the absence of indicators, there is no requirement for an impairment calculation. Determining the existence of indicators requires judgment. Section 3856 provides examples of indicators of impairment, but this is not (and cannot be) an exhaustive list. A financial asset should be assessed for impairment if management has reason to believe it might be impaired even though none of the examples of indicators of impairment in Section 3856 applies.

45-111. The examples of indicators of impairment provided in Section 3856 are:

Paragraph 3856.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 enterprise 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.

45-112. Section 3856 also provides a list of events or circumstances that are not necessarily indicators of impairment, including:

Paragraph 3856.A16 The following events or circumstances are not necessarily indicators of impairment:

- (a) the disappearance of an active market because an enterprise's financial instruments are no longer publicly traded;
- (b) a downgrade of an enterprise's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information; and
- (c) when readily determinable, a decline in the fair value of a financial asset below its cost or amortized cost (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the basic, risk-free interest rate).

45-113. The following Application Example provides a demonstration of an assessment of indicators of impairment:


APPLICATION EXAMPLE	
	<p>Lender Corp. lent one of its customers, Big Box Incorporated (Big Box), \$100,000 on February 14, 20X1. By December 31, 20X1, it was clear customer trends had changed. One of Big Box's competitors had introduced a new product to the market that left Big Box's product outdated and not nearly as popular as it had been. Big Box approached Lender Corp. to renegotiate and extend its repayment terms because it had been experiencing difficulty with its cash flow.</p> <p>Lender Corp. should consider Big Box's request for an extension of its repayment terms and the downturn in Big Box's economic situation to be indications of a significant adverse change in the expected timing or amount of future cash flows associated with its loan receivable.</p>

Measurement of impairment

- 45-114. When there are one or more indicators of impairment and there is a significant adverse change in the expected amount or timing of future cash flows from the financial asset (or group of financial assets), the amount of the impairment must be determined. The impairment reflects the fact that the value of the future cash flows is less than the carrying amount of the financial asset. This reduction may be due to the amount of future cash flows or their timing.
- 45-115. Section 3856 does not define "significant"; judgment is required. The assessment should consider the cash flows expected to be derived over the period the entity expects to hold the financial asset, including any applicable proceeds of disposal. Examples of situations that might be considered a significant adverse change include a change in expectation of collection of a receivable from 60 days to 180 days or receiving notice that a past due receivable will be settled for 80 cents on the dollar.
- 45-116. Estimates of the amounts and timing of expected future cash flows from impaired financial assets reflect management's best judgment, based on reasonable and supportable assumptions and take into account the range of possible outcomes. Short-term receivables with no stated interest rate may be measured at the revised expected amount if the effect of discounting is immaterial. There can be particular challenges in assessing whether equity investments in private (unquoted) companies are impaired. Use of a valuation model may be required.
- 45-117. Except for certain financial assets originated or acquired in related party transactions (see discussion below), when an 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 reduces the carrying amount of the asset, or group of assets, to the highest of the following:
- 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
 - amount that could be realized by selling the asset, or group of assets, at the balance sheet date


- amount the 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.
- 45-118. For a debt instrument originated or acquired in a related party transaction and initially measured at cost, the enterprise reduces the carrying amount of the asset to the highest of:
- the undiscounted cash flows expected to be generated by holding the asset (excluding interest and dividends)
 - the amount that could be realized from selling the asset
 - the amount expected to be received from exercising its right to any collateral held.
- 45-119. For equity instruments originated or acquired in a related party transaction and initially measured at cost, the enterprise reduces the carrying amount to the amount that could be realized by selling the assets at the balance sheet date.
- 45-120. Section 3856 assumes the holder of the asset will take whatever action is necessary to maximize cash flows from the impaired financial asset. However, it does not presume a course of action. This means the reporting entity may manage an asset in a different manner from that corresponding to the measurement. For example, collateral backing an asset may be worth more than either the present value of the asset's future cash flows or the amount that could be realized on sale of the asset. The value of the collateral would be used to measure impairment even if the reporting entity does not intend to foreclose on the asset and realize the collateral. Even though conceptually the net realizable amount from a hypothetical sale of the asset should be equal to the higher of the net realizable value of the collateral or the net present value of the future cash flows, Section 3856 does not presume that markets for these assets are liquid or perfect.
- 45-121. The interest rate to be used to discount future cash flows is determined by judgment. The rate should reflect the type of asset under consideration. For example, a loan should be remeasured using the rate that would be charged for a loan with comparable term, conditions and quality at the balance sheet date. Cash flows from other interest-bearing assets should be discounted using current yields for those assets (if observable) or comparable assets.
- 45-122. Impairment losses realized on unquoted equity instruments or linked derivative assets that must be settled by delivery of unquoted equity instruments are more difficult to measure than interest-bearing investments. Estimates of the fair value of the shares and cash flows that might reasonably be expected over the anticipated hold period are required. Future cash flows might be discounted using the required yield for an investment with comparable terms and risk or possibly using an estimate of the entity's weighted average cost of capital.
- 45-123. If the reporting entity has granted concessions to a borrower by reducing the interest rate to below the current market rate, the amount of the loss reported will include a component for foregone interest.

45-124. The following Application Example illustrates a scenario with a reduction of interest:

APPLICATION EXAMPLE				
	<p>Rich Co. extended a \$120,000, three-year loan to Sad Co. on June 1, 20X0. Rich Co. and Sad Co are not related parties.</p> <p>Sad Co. was required to pay interest at 10%, with principal due in full on June 30, 20X3.</p> <p>Sad Co. lost its most significant customer to bankruptcy shortly after the loan was extended.</p> <p>Sad Co. made all interest payments in 20X0. In January 20X1, Sad Co. asked for a reduction in the interest rate to 5% and an extension on the final payment to June 30, 20X4. The loan was not collateralized.</p> <p>Depending on market rates of interest, the impairment loss Rich Co. calculates is:</p>			
	Market interest rate	5%	10%	12%
	Present value of renegotiated cash flows (interest and principal)	\$121,394	\$108,703	\$104,330
	Carrying amount of loan	<u>120,000</u>	<u>120,000</u>	<u>120,000</u>
	Impairment loss recognized	\$0 =====	\$11,297 =====	\$15,670 =====
		<p>Because the loan has been renegotiated to the market rate of interest, no impairment loss is recognized.</p>	<p>The impairment loss represents the difference between the present value of the loan using the new interest rate and the present value of the loan using the market rate. If the term of the loan had not been extended, the loss would have been \$9,917.</p>	<p>The impairment loss represents the difference between the present value of the loan using the new interest rate and the present value of the loan using the market interest rate.</p>
	<p>Subsequent to recognizing the write-down, Rich Co. received cash interest payments at 5% and recognized total interest income at the relevant market rate (representing periodic cash interest payments plus accretion). If Sad Co. rebuilds its customer base, all or part of the loss must be reversed, assuming everything else is equal.</p>			

APPLICATION EXAMPLE	
	(Note: If Rich Co. and Sad Co are related parties, then the measurement basis is undiscounted cash flows, so a change in the interest rate would not impact the undiscounted cash flows.)

45-125. In some cases, a range of cash flow receipts is reasonably likely. In this case, the probability of different outcomes should be taken into account as illustrated in the following Application Example:


APPLICATION EXAMPLE																																							
	<p>Lender Corp. lent one of its customers, Big Box Incorporated (Big Box), an unrelated party, \$100,000 on February 14, 20X1. Lender Corp.'s loan to Big Box had a carrying amount of \$100,000 on December 31, 20X1.</p> <p>By December 31, 20X1, it had become clear that customer trends had changed. One of Big Box's competitors had introduced a new product to the market with immediate success that left Big Box's product outdated and not nearly as popular as it had been.</p> <p>After much discussion with Big Box's management, Lender Corp. agreed to extend the repayment period to February 14, 20X6, from the original due date of February 14, 20X4.</p> <p>The amount Big Box expects to realize by exercising its right to collateral, net of all costs necessary to exercise those rights is \$70,000.</p> <p>Assume the loan is priced at 3.25%, paid monthly, and that the current market rate of interest appropriate to Big Box is 4.5%.</p> <table border="0" style="width: 100%; margin-top: 20px;"> <thead> <tr> <th style="text-align: left;">Probability</th> <th style="text-align: left;">Outcome</th> <th style="text-align: right;">Probability weighted gross cash flows</th> <th style="text-align: right;">Present value</th> </tr> </thead> <tbody> <tr> <td>5%</td> <td>No payments</td> <td style="text-align: right;">\$0</td> <td style="text-align: right;">\$0</td> </tr> <tr> <td>5%</td> <td>\$30,000 principal plus interest until Feb. 20X4</td> <td style="text-align: right;">1,852</td> <td style="text-align: right;">1,572</td> </tr> <tr> <td>10%</td> <td>\$50,000 principal plus interest until Feb. 20X5</td> <td style="text-align: right;">6,029</td> <td style="text-align: right;">5,097</td> </tr> <tr> <td>20%</td> <td>\$70,000 principal plus all interest</td> <td style="text-align: right;">16,708</td> <td style="text-align: right;">14,079</td> </tr> <tr> <td>60%</td> <td>\$100,000 principal plus all interest</td> <td style="text-align: right;"><u>68,125</u></td> <td style="text-align: right;"><u>57,220</u></td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">\$92,714</td> <td style="text-align: right;">\$77,968</td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">=====</td> <td style="text-align: right;">=====</td> </tr> </tbody> </table> <p>Lender Corp. recorded an impairment in the amount of \$22,032 (\$100,000 less \$77,968) through net income at December 31, 20X1 as follows:</p> <table border="0" style="width: 100%; margin-top: 20px;"> <tr> <td style="padding-left: 40px;">Dr. Credit loss</td> <td style="text-align: right;">\$22,032</td> <td></td> </tr> <tr> <td style="padding-left: 40px;">Cr. Loan receivable (or allowance for loan loss)</td> <td></td> <td style="text-align: right;">\$22,032</td> </tr> </table>	Probability	Outcome	Probability weighted gross cash flows	Present value	5%	No payments	\$0	\$0	5%	\$30,000 principal plus interest until Feb. 20X4	1,852	1,572	10%	\$50,000 principal plus interest until Feb. 20X5	6,029	5,097	20%	\$70,000 principal plus all interest	16,708	14,079	60%	\$100,000 principal plus all interest	<u>68,125</u>	<u>57,220</u>			\$92,714	\$77,968			=====	=====	Dr. Credit loss	\$22,032		Cr. Loan receivable (or allowance for loan loss)		\$22,032
Probability	Outcome	Probability weighted gross cash flows	Present value																																				
5%	No payments	\$0	\$0																																				
5%	\$30,000 principal plus interest until Feb. 20X4	1,852	1,572																																				
10%	\$50,000 principal plus interest until Feb. 20X5	6,029	5,097																																				
20%	\$70,000 principal plus all interest	16,708	14,079																																				
60%	\$100,000 principal plus all interest	<u>68,125</u>	<u>57,220</u>																																				
		\$92,714	\$77,968																																				
		=====	=====																																				
Dr. Credit loss	\$22,032																																						
Cr. Loan receivable (or allowance for loan loss)		\$22,032																																					

APPLICATION EXAMPLE	
	By December 31, 20X2, the present value of the cash flows expected to be generated by holding the loan was estimated to be \$78,700, while the amount expected to be realized by exercising rights to collateral (net of all costs necessary to exercise those rights) was \$70,000. Lender does not record the increase because there is no indication the conditions that caused it to evaluate the loan for impairment have improved (see below).

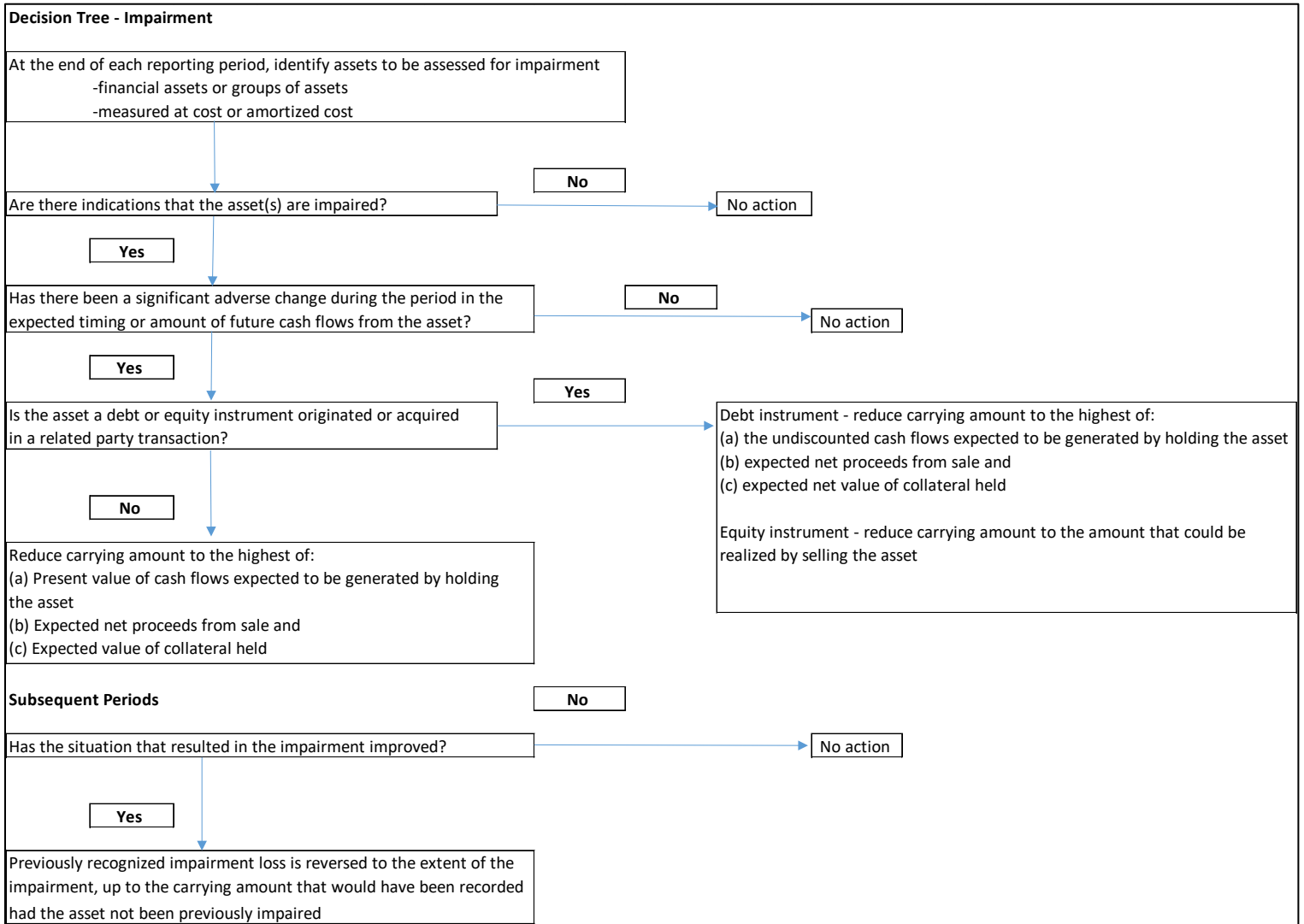
Reversal of impairment loss

- 45-126. At each reporting date, all assets previously identified as impaired are reviewed to determine whether all or part of the impairment loss should be reversed. When an increase in value of the asset can be related to an improvement in the condition(s) that caused the loss, a gain is recognized. The carrying amount of the asset may not be increased above the amount that would have been reported at the reporting date had an impairment loss not been previously recorded. The amount of the reversal is recognized in net income in the period the reversal occurs.
- 45-127. Examples of circumstances that might indicate an impairment reversal may be possible include:
- The customer or issuer previously experiencing significant financial difficulty seems to be doing better. This may be evidenced by faster payments, the absence or improvement of conditions that threatened default, or a commitment to resume interest or principal payments.
 - A contract has been renegotiated to incorporate commercial terms appropriate to a party free from liquidity, solvency, or profitability concerns, or reinstatement of dividend payments.
 - The entity has emerged from receivership or bankruptcy protection.
 - The technological, market, economic or legal environment in which the customer or issuer operates has improved. A recovery in the fair value of an investment in an equity instrument above its cost may be indicative of improvement, but the reporting entity should consider whether the improvement is specific to the issuer and sustainable through its intended holding period. Other indicators might include:
 - increased popularity of the issuer's or customer's product
 - structural changes in the customer's or issuer's industry, such as new technology or a change in the number of competitors
 - changes in external variables, such as environmental or tax laws.

Using the facts from the preceding scenario, the following Application Example demonstrates an impairment loss reversal:

APPLICATION EXAMPLE				
	<p>By December 31, 20X2, it had become clear the new product introduced by Big Box's competitor was faulty and was receiving negative exposure in the media. As a result, the market had a renewed interest in Big Box's products noting their stable reputation for quality and reliability. Big Box's management recently contacted Lender Corp. and informed Lender Corp that Big Box intended to repay the loan in full over the next five years.</p> <p>Lender was cautiously optimistic and revised its estimate of expected cash flows as follows:</p>			
	Probability	Outcome	Probability weighted gross cash flows	Present value
	0%	No further payments	\$0	\$0
	5%	\$40,000 principal plus all interest	2,515	2,207
	5%	\$60,000 principal plus all interest	3,515	3,077
	10%	\$80,000 principal plus all interest	9,029	7,894
	80%	\$100,000 principal plus all interest	<u>88,233</u>	<u>77,074</u>
			\$103,292 =====	\$90,253 =====
	<p>The value of the collateral increased to \$75,000.</p> <p>Lender increased the carrying amount of the loan to Big Box from \$77,968 to \$90,253 and recorded the following journal entry:</p>			
		Dr. Loan receivable (or allowance for loan losses)	\$12,285	
	Cr. Credit loss		\$12,285	

45-128. The following decision tree summarizes key concepts related to impairment of a financial instrument:



FORGIVENESS

- 45-129. A related party financial asset or part thereof 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. Prior to calculating the amount of forgiveness, the financial asset is assessed for impairment.
- 45-130. Profit-oriented enterprises that forgive all or part of a related party financial asset recognize this forgiveness in:
- equity: when the original transaction is not in the normal course of operations
 - income: when
 - the original transaction is in the normal course of operations or
 - it is impracticable to determine whether the forgiven related party financial asset originated in the normal course of operations or not in the normal course of operations.
- 45-131. Not-for-profit organizations recognize the forgiveness of a related party financial asset in the statement of operations.

PRESENTATION

Offsetting

- 45-132. Offsetting refers to the presentation of a recognized financial asset and a recognized financial liability as a single net asset or liability on the face of the balance sheet. Neither instrument is actually derecognized (see below for further discussion on derecognition).
- 45-133. Offsetting differs from derecognition in the following ways:
- No gain or loss is recognized.
 - Unlike a transfer of assets that results in a sale treatment because the entity surrenders control (i.e., a derecognition transaction), financial assets offset by financial liabilities continue to be controlled by their owner.
 - Unlike an extinguishment of debt, where the debtor is legally released from its obligation (i.e., a derecognition transaction), the debtor remains obligated to repay the debt that is offset against one or more assets.
- 45-134. The determination of whether financial assets should be offset with financial liabilities is important because gross or net presentation can have a significant impact on the following key ratios (among others) that are sometimes used to measure liquidity and profitability:
- current ratio, quick ratio
 - return on assets

- debt to equity or other leverage measures.
- 45-135. The determination of whether financial assets should be offset with financial liabilities can also impact the calculations a bank may use to limit a line of credit. For example, some agreements limit the balance to 75% of the accounts receivable balance.
- 45-136. When an enterprise has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. Financial assets and liabilities must be offset when the two conditions in paragraph 3856.24 are met:

Paragraph 3856.24 *A financial asset and a financial liability shall be offset, and the net amount reported in the balance sheet, only when an enterprise:*

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

Legal right of offset

- 45-137. A legally enforceable right of offset is a function of both the facts and circumstances of the transaction and its governing laws and regulations. In some cases, laws or regulations, or the operation of common law, may contradict rights otherwise provided by contract.
- 45-138. A right of offset that is legally enforceable only in the event of default of one of the parties to the contract does not satisfy the requirement that the right of offset be currently enforceable.

Intent to settle net

- 45-139. The intention condition is necessary to faithfully represent the entity's expected sources and use of cash. Intent to settle net must be documented or supported by the entity's history of offset in similar situations. In the absence of an explicit settlement mechanism and date, an entity cannot assert that it intends to settle net on two or more transactions.

DERECOGNITION

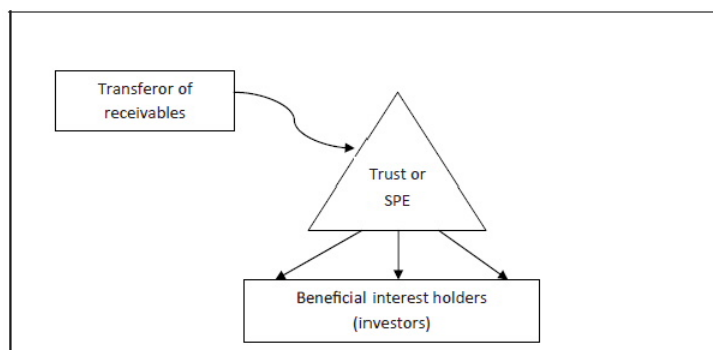
- 45-140. Derecognition refers to the removal of a previously recognized financial asset or financial liability from an entity's balance sheet. Section 3856 provides guidance on securitization of receivables and derecognition of financial liabilities. The focus of the guidance on transfers of assets is on transactions that result in the transferor retaining some continuing interest in the transferred assets.

Financial Assets

- 45-141. The most common scenario for derecognition occurs when the financial asset is settled (i.e., the holder of the financial asset receives payment from the creditor). However, in some cases the holder may sell financial assets to a third party. This situation is addressed in Section 3856 as follows:

Paragraph 3856.25 *An enterprise shall derecognize receivables transferred to another enterprise only when control has been surrendered (see Appendix B).*

- 45-142. As indicated in paragraph 3856.25 above, Appendix B to Section 3856 provides more guidance on a particular form of transfer called securitization.
- 45-143. An originator of a typical securitization (i.e., the transferor) transfers a portfolio of receivables to a special purpose entity (SPE), commonly a trust or co-ownership pool. In certain "pass-through" and "pay-through" securitizations, receivables are transferred to the SPE at inception of the securitization, and no further transfers are made. All cash collections are paid to the holders of beneficial interests in the SPE. In certain "revolving-period" securitizations, receivables are transferred at inception and also periodically (e.g., daily or monthly) thereafter for a defined period, referred to as the revolving period. During the revolving period, the SPE uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.
- 45-144. In these structures, beneficial interests in the SPE are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the SPE.
- 45-145. Receivables such as mortgage loans, automobile loans, trade receivables, credit card receivables and other revolving charge accounts are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans (i.e., multi-family residential mortgages and commercial property mortgages). Securitizations of loans secured by chattel mortgages on motor vehicles and other equipment (including direct financing or sales-type leases) are also common. Both financial and non-financial assets can be securitized. Life insurance policy loans, patent and copyright royalties and even taxi medallions have been securitized; however, securitizations of non-financial assets are outside the scope of Section 3856.
- 45-146. A typical securitization transaction is shown in the following diagram:



- 45-147. Securitizations, including pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 3856.B5 qualify for sale accounting:

Paragraph 3856.B5 A transfer of receivables (or all or a portion of a receivable) in which the transferor surrenders control over those receivables is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

- (a) The transferred assets have been isolated from the transferor — put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 3856.B6-.B7).
- (b) Each transferee (or, if the transferee is a qualifying special-purpose entity (SPE) (see paragraph 3856.B14), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (see paragraphs 3856.B8-.B13).
- (c) The transferor does not maintain effective control over the transferred assets through either:
 - (i) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 3856.B26-.B28 and 3856.B34-.B37); or
 - (ii) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (see paragraphs 3856.B29-.B33).

- 45-148. As a result of a securitization, the transferor may have certain assets and/or liabilities related to the securitized receivables. All financial assets obtained or retained and liabilities incurred by the originator of a securitization that qualifies as a sale are recognized and measured as provided for in paragraph 3856.B39:

Paragraph 3856.B39 Upon completion of a transfer of receivables that satisfies the conditions to be accounted for as a sale (see paragraph 3856.B5), the transferor (seller):


- (a) derecognizes all assets sold;
- (b) recognizes all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (see paragraphs 3856.B41 and 3856.B54-.B56);
- (c) initially measures at fair value assets obtained and liabilities incurred in a sale (see paragraphs 3856.B44-.B46) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (see paragraph 3856.B47); and
- (d) recognizes in income any gain or loss on the sale.

The transferee recognizes all assets obtained and any liabilities incurred and initially measures them at fair value (in aggregate, presumptively the price paid).

- 45-149. The amount measured includes the implicit forward contract to sell new receivables during a revolving period. This contract may become valuable or onerous to the transferor as interest rates and other market conditions change.
- 45-150. Receivables are derecognized only when control has been surrendered. The conditions necessary to achieve transfer of control are set out in paragraphs 3856.B5-3856.B37. Paragraphs 3856.B38-.B40 set out the accounting steps to derecognize the transferred assets, recognize assets obtained or retained in the transfer transaction and liabilities incurred or assumed. Measurement requirements for the items incurred and retained are set out in paragraphs 3856.B41-3856.B47. Accounting for revolving-period securitizations, sales-type and direct-financing lease receivables, changes that result in the transferor regaining control of receivables sold, servicing assets and liabilities, retained interests subsequent to a transfer accounted for as a sale and secured borrowings are addressed in paragraphs 3865.B48-3856.B58.


Measurement of interest held after a transfer of receivables

- 45-151. The following Application Example outlines recording transfers with proceeds of cash, derivatives, and other liabilities:

APPLICATION EXAMPLE															
	<p>Assuming all parties are unrelated, Company A sells loans with a fair value of \$1,100 and a carrying amount of \$1,000. Company A retains no servicing responsibilities but obtains an option to purchase loans from the transferee similar to the loans sold (which are readily obtainable in the market) and assumes a limited recourse obligation to repurchase delinquent loans. Company A agrees to provide the transferee a return at a floating rate of interest, even though the contractual terms of the loan are at a fixed rate (that provision is effectively an interest rate swap).</p> <p>Fair values</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Cash proceeds</td> <td style="text-align: right;">\$1,050</td> </tr> <tr> <td>Interest rate swap</td> <td style="text-align: right;">40</td> </tr> <tr> <td>Call option</td> <td style="text-align: right;">70</td> </tr> <tr> <td>Recourse obligation</td> <td style="text-align: right;">60</td> </tr> </table> <p>Net proceeds</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Cash received</td> <td style="text-align: right;">\$1,050</td> </tr> <tr> <td>Plus: Call option</td> <td style="text-align: right;">70</td> </tr> <tr> <td style="padding-left: 20px;">Interest rate swap</td> <td style="text-align: right;">40</td> </tr> </table>	Cash proceeds	\$1,050	Interest rate swap	40	Call option	70	Recourse obligation	60	Cash received	\$1,050	Plus: Call option	70	Interest rate swap	40
Cash proceeds	\$1,050														
Interest rate swap	40														
Call option	70														
Recourse obligation	60														
Cash received	\$1,050														
Plus: Call option	70														
Interest rate swap	40														

APPLICATION EXAMPLE		
	Less: Recourse obligation	(60)
	Net proceeds	\$1,100
		=====
	Gain on sale	
	Net proceeds	\$1,100
	Carrying amount of loans sold	<u>1,000</u>
	Gain on sale	\$100
		=====
	Journal entries	
	Dr. Cash	\$1,050
	Dr. Interest rate swap	40
	Dr. Call option	70
	Cr. Loans	\$1,000
	Cr. Recourse obligation	60
	Cr. Gain on sale	100
	To record transfer	


45-152. The following Application Example outlines recording transfers of partial interests:

APPLICATION EXAMPLE				
	<p>Assuming all parties are unrelated, Company B sells a pro-rata 90% interest in loans with a fair value of \$1,100 and carrying amount of \$1,000. There is no servicing asset or liability because Company B estimates the benefits of servicing are sufficient to compensate for its servicing responsibilities. (Servicing assets and liabilities are discussed in further detail immediately following this example.)</p>			
	Fair values			
	Cash proceeds for 90% interest sold	\$990		
	10% interest retained $[(\$990 \div 9/10) \times 1/10]$	110		
		Fair value	Percentage of total fair value	Allocated carrying amount
	Carrying amount based on relative fair values			
	Nine-tenths interest sold	\$990	\$90	\$900
	One-tenth interest retained	<u>110</u>	<u>10</u>	<u>100</u>
	Total	\$1,100	\$100	\$1,000
		=====	=====	=====

APPLICATION EXAMPLE			
Gain on sale			
Net proceeds			\$990
Carrying amount of loans sold			<u>900</u>
Gain on sale			\$90
Journal entries			
Dr. Cash		\$990	
Cr. Loans			\$900
Cr. Gain on sale			90
To record transfer			


Servicing assets and liabilities

- 45-153. Transferees sometimes agree to take on servicing responsibilities for transferred assets. Servicing activities include the following:
- collecting principal, interest, and escrow payments from borrowers
 - paying taxes and insurance from escrowed funds
 - monitoring delinquencies
 - executing foreclosure if necessary
 - temporarily investing funds, pending distribution.
- 45-154. When an obligation is undertaken to service receivables, a servicing asset or a servicing liability is recognized, unless:
- the assets are securitized
 - all the resulting securities are retained and
 - the securities are classified and measured on an amortized cost basis.
- 45-155. When the future benefits of servicing the assets are not expected to compensate the transferor adequately for performing such work, the result is a servicing liability rather than an asset. For example, in the transaction illustrated above, if the transferor had agreed to service the loans without explicit compensation and it was estimated that the fair value of that servicing obligation was \$50, net proceeds would have been reduced to \$1,050, the gain on sale would have been reduced to \$50 and the transferor would have reported a servicing liability of \$50. These revised facts are illustrated below. Servicing becomes a distinct asset or liability only when contractually separated from the underlying assets by sale, when securitization of the assets occurs with servicing retained, separately purchased or there is an assumption of servicing responsibility.
- 45-156. The following Application Example outlines recognizing a servicing liability in a transfer of receivables (continued from above):

APPLICATION EXAMPLE	
	<p>Assuming all parties are unrelated, Company C sells loans with a fair value of \$1,100 and a carrying amount of \$1,000. Company C agreed to service the loans without explicit compensation, and it estimates the fair value of the servicing obligation is \$50. Company C obtains an option to purchase loans from the transferee similar to the loans sold (which are readily obtainable in the market) and assumes a limited recourse obligation to repurchase delinquent loans. Company C agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed (effectively an interest rate swap).</p>
	Fair values
Cash proceeds	\$1,050
Interest rate swap	40
Call option	70
Recourse obligation	60
Servicing liability	50
	Net proceeds
Cash received	\$1,050
Plus: Call option	70
Interest rate swap	40
Less: Recourse obligation	(60)
Servicing liability	<u>(50)</u>
Net proceeds	\$1,050
	=====
	Gain on sale
Net proceeds	\$1,050
Carrying amount of loans sold	<u>1,000</u>
Gain on sale	\$50
	=====
	Journal entries
Dr. Cash	\$1,050
Dr. Interest rate swap	40
Dr. Call option	70
Cr. Loans	\$1,000
Cr. Recourse obligation	60
Cr. Servicing liability	50


APPLICATION EXAMPLE		
	Cr. Gain on sale	50
	To record transfer	

45-157. Application Example outlines the sale of receivables with servicing retained:

APPLICATION EXAMPLE				
	<p>Assuming all parties are unrelated, Company D holds \$1,000 of loans that yield 10% interest income for their estimated lives of nine years. Company D sells the \$1,000 principal plus the right to receive interest income of 8% to another entity for \$1,000. Company D will continue to service the loans. The contract stipulates that its compensation for performing the servicing is the right to receive half the interest income not sold. The remaining half of the interest income not sold is considered an interest-only strip receivable. At the date of transfer, the fair value of the loans, including servicing, is \$1,100. The fair value of the servicing asset is \$40.</p>			
	Fair values			
	Cash proceeds		\$1,000	
	Servicing asset		40	
	Interest-only strip receivable		60	
		Fair value	Percentage of total fair value	Allocated carrying amount
	Carrying amount based on relative fair values			
	Loans sold	\$1,000	91.0	\$910
	Servicing asset	40	3.6	36
	Interest-only strip receivable	<u>60</u>	<u>5.4</u>	<u>54</u>
Total	\$1,100	100.0	\$1,000	
Gain on sale				
Net proceeds			\$1,000	
Carrying amount of loans sold			<u>910</u>	
Gain on sale			\$90	
			=====	
Journal entries				
Dr. Cash		\$1,000		
Cr. Loans			\$910	

APPLICATION EXAMPLE			
	Cr. Gain on sale		90
	To record transfer		
	Dr. Servicing asset	\$36	
	Dr. Interest-only strip receivable	54	
	Cr. Loans		\$90
	To record servicing asset and interest-only strip receivable		

45-158. The Application Example above demonstrates how a transferor would account for a simple securitization in which servicing is retained. Company D might instead transfer the receivables to a corporation or a trust that is a qualifying SPE. The qualifying SPE then securitizes the loans by selling beneficial interests to the public. The qualifying SPE pays the cash proceeds to the original transferor, which accounts for the transfer as a sale and derecognizes the receivables, assuming the criteria in paragraph 3856.B5 are met. Securitizations often combine the elements shown in all the previous examples, as illustrated in the Application Example below:

APPLICATION EXAMPLE											
	<p>Assuming all parties are unrelated, Company E originates \$1,000 of pre-payable loans that yield 10% interest income for their nine-year expected lives. Company E sells nine-tenths of the principal plus interest of 8% to another entity. Company E will continue to service the loans; the contract stipulates that its compensation for performing the servicing is 2% of the interest income not sold. Company E retains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the market) and incurs a limited-recourse obligation to repurchase delinquent loans.</p>										
	<p>Fair values</p> <table> <tr> <td>Cash proceeds</td> <td style="text-align: right;">\$900</td> </tr> <tr> <td>Call option</td> <td style="text-align: right;">70</td> </tr> <tr> <td>Recourse obligation</td> <td style="text-align: right;">60</td> </tr> <tr> <td>Servicing asset</td> <td style="text-align: right;">90</td> </tr> <tr> <td>One-tenth interest retained</td> <td style="text-align: right;">100</td> </tr> </table>	Cash proceeds	\$900	Call option	70	Recourse obligation	60	Servicing asset	90	One-tenth interest retained	100
Cash proceeds	\$900										
Call option	70										
Recourse obligation	60										
Servicing asset	90										
One-tenth interest retained	100										
	<p>Net proceeds</p> <table> <tr> <td>Cash received</td> <td style="text-align: right;">\$900</td> </tr> <tr> <td>Plus: Call option</td> <td style="text-align: right;">70</td> </tr> <tr> <td>Less: Recourse obligation</td> <td style="text-align: right;"><u>(60)</u></td> </tr> <tr> <td>Net proceeds</td> <td style="text-align: right;">\$910</td> </tr> <tr> <td></td> <td style="text-align: right;">=====</td> </tr> </table>	Cash received	\$900	Plus: Call option	70	Less: Recourse obligation	<u>(60)</u>	Net proceeds	\$910		=====
Cash received	\$900										
Plus: Call option	70										
Less: Recourse obligation	<u>(60)</u>										
Net proceeds	\$910										
	=====										

APPLICATION EXAMPLE			
	Fair value	Percentage of total fair value	Allocated carrying amount
Carrying amount based on relative fair values			
Interest sold	\$910	83	\$830
Servicing asset	90	8	80
One-tenth interest retained	<u>100</u>	<u>9</u>	<u>90</u>
Total	\$1,100	\$100	\$1,000
	=====	===	=====
Gain on sale			
Net proceeds			\$910
Carrying amount of loans sold			<u>830</u>
Gain on sale			\$80
			=====
Journal entries			
Dr. Cash		\$900	
Dr. Call option		70	
Cr. Loans			\$830
Cr. Recourse obligation			60
Cr. Gain on sale			80
To record transfer			
Dr. Servicing asset		\$80	
Cr. Loans			\$80
To record servicing asset			
At the time of the transfer, Company E reports its one-tenth retained interest in the loans at its allocated carrying amount of \$90.			

45-159. The following Application Example outlines recording transfers if it is not practicable to estimate a fair value:

APPLICATION EXAMPLE



Assuming all parties are unrelated, Company F sells loans with a carrying amount of \$1,000 to another entity for cash plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the market) and incurs a limited recourse obligation to repurchase any delinquent loans.

Company F undertakes to service the transferred assets for the other entity. In Situation I, Company F finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenue will be more than adequate compensation for performing the servicing. In Situation II, Company F finds it impracticable to estimate the fair value of the recourse obligation.

Fair value	Situation I	Situation II
Cash proceeds	\$1,050	\$1,050
Servicing asset	—	40
Call option	70	70
Recourse obligation	60	—
Fair value of loans transferred	1,100	1,100

Net proceeds	Situation I	Situation II
Cash received	\$1,050	\$1,050
Plus: Call option	70	70
Less: Recourse obligation	<u>(60)</u>	<u>—</u>
Net proceeds	\$1,060	\$1,120
	=====	=====


Carrying amount based on relative fair values (Situation I)	Fair value	Percentage of total fair value	Allocated carrying amount
Loans sold	\$1,060	100	\$1,000
Servicing asset	<u>—</u>	<u>—</u>	<u>—</u>
Total	\$1,060	100	\$1,000
	=====	===	=====

Carrying amount based on relative fair values (Situation II)	Fair value	Percentage of total fair value	Allocated carrying amount
Loans sold	\$1,120	97	\$970
Servicing asset	<u>40</u>	<u>3</u>	<u>30</u>
Total	\$1,160	100	\$1,000

APPLICATION EXAMPLE			
	Journal entries to record transfer	Situation	
		I	II
	Dr. Cash	\$1,050	\$1,050
	Dr. Servicing asset	—	30
	Dr. Call option	70	70
	Cr. Loans	\$1,000	\$1,000
	Cr. Recourse obligation	60	150
	Cr. Gain on sale	60	—

Sales-type and direct financing of lease receivables

45-160. The following Application Example outlines recording transfers of lease financing receivables with residual values:

APPLICATION EXAMPLE																							
	<p>Assuming all parties are unrelated, at the beginning of the second year of a 10-year sales-type lease, Company G sells a nine-tenths interest in the minimum lease payments for \$505, retains a one-tenth interest in the minimum lease payments and a 100% interest in the unguaranteed residual value of leased equipment. Company G receives no explicit compensation for servicing, but it estimates the other benefits of servicing are sufficient to compensate for its servicing responsibilities and, hence, initially records no servicing asset or liability.</p> <p>The carrying amounts and related gain computation are as follows:</p> <table> <thead> <tr> <th colspan="2">Carrying amounts</th> </tr> </thead> <tbody> <tr> <td>Minimum lease payments</td> <td style="text-align: right;">\$540</td> </tr> <tr> <td>Unearned income related to minimum lease payments</td> <td style="text-align: right;"><u>370</u></td> </tr> <tr> <td>Gross investment in minimum lease payments</td> <td style="text-align: right;"><u>910</u></td> </tr> <tr> <td>Unguaranteed residual value</td> <td style="text-align: right;">30</td> </tr> <tr> <td>Unearned income related to residual value</td> <td style="text-align: right;"><u>60</u></td> </tr> <tr> <td>Gross investment in residual value</td> <td style="text-align: right;"><u>90</u></td> </tr> <tr> <td>Total gross investment in financing lease receivable</td> <td style="text-align: right;">\$1,000</td> </tr> </tbody> </table> <table> <thead> <tr> <th colspan="2">Gain on sale</th> </tr> </thead> <tbody> <tr> <td>Cash received</td> <td style="text-align: right;">\$505</td> </tr> <tr> <td>Nine-tenths of carrying amount of gross investment in minimum lease payments</td> <td style="text-align: right;">819</td> </tr> </tbody> </table>	Carrying amounts		Minimum lease payments	\$540	Unearned income related to minimum lease payments	<u>370</u>	Gross investment in minimum lease payments	<u>910</u>	Unguaranteed residual value	30	Unearned income related to residual value	<u>60</u>	Gross investment in residual value	<u>90</u>	Total gross investment in financing lease receivable	\$1,000	Gain on sale		Cash received	\$505	Nine-tenths of carrying amount of gross investment in minimum lease payments	819
Carrying amounts																							
Minimum lease payments	\$540																						
Unearned income related to minimum lease payments	<u>370</u>																						
Gross investment in minimum lease payments	<u>910</u>																						
Unguaranteed residual value	30																						
Unearned income related to residual value	<u>60</u>																						
Gross investment in residual value	<u>90</u>																						
Total gross investment in financing lease receivable	\$1,000																						
Gain on sale																							
Cash received	\$505																						
Nine-tenths of carrying amount of gross investment in minimum lease payments	819																						

APPLICATION EXAMPLE		
Nine-tenths of carrying amount of unearned income related to minimum lease payments		(333)
Net carrying amount of minimum lease payments sold		<u>486</u>
Gain on sale		\$19
		====
Journal entries		
Dr. Cash	\$505	
Dr. Unearned income	333	
Cr. Lease receivable		\$819
Cr. Gain on sale		19
These entries record sale of nine-tenths of the minimum lease payments at the beginning of year two.		

Financial Liabilities

Extinguishment of financial liabilities

- 45-161. A financial liability (or a part of a financial liability) that has been extinguished should be derecognized (i.e., removed from the enterprise's balance sheet). A liability is extinguished when the obligation is discharged, cancelled or expires, as indicated in the following paragraph:

Paragraph 3856.26 *An enterprise shall remove a financial liability (or a 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.)*

Extinguishment of financial liabilities between related parties

- 45-162. Section 3856 includes specific guidance for transactions between related parties. A transaction between related parties to replace all or part of a debt instrument with another debt instrument, or to modify the terms of an existing financial liability, is accounted for as an extinguishment of the original liability and the recognition of a new financial instrument. The difference between the carrying amount of a financial instrument extinguished and the amount of the consideration paid, including any non-cash assets transferred, liabilities assumed or equity instruments issued, shall be recognized in:
- Equity: when the original transaction that resulted in the issuance of the financial liability was not in the normal course of operations
 - Net income: when the original transaction was in the normal course of operations or it is impracticable to determine whether the amount extinguished was or was not in the normal course of operations.

- 45-163. The specific guidance for transactions between related parties to replace all or part of a debt instrument is provided as follows:

Paragraph 3856.27A A transaction between related parties to replace all or a part of a debt instrument with another instrument or to modify the terms of an existing financial liability is accounted for as an extinguishment of the original financial liability and the recognition of a new financial instrument. (Paragraph 3856.A60A provides related application guidance.)

Paragraph 3856.A60A An enterprise initially measures equity instruments issued to a creditor to extinguish all or part of a financial liability issued in a related party transaction at the carrying amount of the liability extinguished.

Paragraph.28A *Except as specified in paragraph 3856.28B, 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 3856.19AA

- 45-164. Section 3856 provides guidance on distinguishing between an extinguishment and a modification of a financial liability. For transactions that are not between related parties, a renegotiation of a financial liability is considered to be an extinguishment when the new terms of the instrument "differ substantially" from the original terms. Paragraph 3856.A52 sets out the two circumstances when a renegotiated liability is considered to differ substantially from the original:

1. 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 of the original liability or
2. There is a change in creditor and the original debt is legally discharged.

- 45-165. Cash flows can be affected by changes in principal amounts, interest rates, or maturity. They can also be affected by fees exchanged between the debtor and creditor to effect changes in attributes, such as:

- recourse or non-recourse features
- priority of the obligation


- collateral
 - debt covenants and/or waivers
 - the guarantor
 - call or redemption features.
- 45-166. If the terms of a debt instrument are changed or modified in any of the ways described above and the resulting cash flow effect on a present-value basis is at least 10%, the changes are substantial and should be accounted for as an extinguishment of the original debt.
- 45-167. The following scenarios do not result in an extinguishment of debt and would not result in gain or loss on recognition:
- an announcement by the debtor of its intent to call a debt instrument at the first call date
 - an agreement with a creditor that a debt instrument will be redeemed that is held by a different party to whom the creditor has sold or otherwise transferred the debt.
- 45-168. To determine whether a transaction meets the conditions to be considered an extinguishment of debt (as set out in paragraph 3856.A52(a)), the following should be taken into account:
- The discounted cash flows calculation includes
 - all cash flows specified by the terms of the new debt instrument, plus
 - any amounts (including fees) paid by the debtor to the creditor and allocated to the debt instrument, less
 - any amounts (including fees) received by the debtor from the creditor as part of the modification or exchange.
 - If the original debt instrument and/or the new debt instrument have a floating interest rate, then the variable rate in effect at the date of the modification or exchange is to be used to calculate the cash flows of the variable rate instrument.
 - If either the new debt instrument or the original debt instrument is callable or puttable, then separate cash flow analyses are to be performed assuming exercise and non-exercise of the call or put. The cash flow assumptions that generate the smaller change would be the basis for determining whether the 10 % threshold has been met.
 - If the debt instruments contain contingent payment terms or unusual interest rate terms, judgment should be used to determine the appropriate cash flows.
 - The discount rate to be used to calculate the present value of the cash flows is the effective interest rate, for accounting purposes, of the original debt instrument.
 - If within a year of the current transaction, the debt has been modified or exchanged without being deemed to be a settlement, then the original debt terms that existed a year ago should be considered to determine whether the current modification or exchange is an extinguishment.

- 45-169. If the present values of the cash flows of the original and new debt instruments differ by at least 10%, then:
- the new debt instrument is initially recorded at its fair value adjusted by any fees or transaction costs incurred to renegotiate the debt, as appropriate
 - the difference between the fair value of the new liability and the carrying amount of the original liability, including all fees and transaction costs originally included in that carrying amount, is recognized as a gain or loss on extinguishment of the original liability
 - the fair value is used to determine the effective interest rate of the new instrument if the effective interest method is used. If the effective interest method is *not* used, the difference between the principal amount of the new debt and its carrying amount must be amortized over the life of the new debt on a systematic basis.
- 45-170. If the present values of the cash flows of the original and new debt instruments differ by less than 10%, any fees or costs associated with the renegotiation are added to the carrying amount of the new debt instrument and amortized over the remaining life of the instrument together with any fees or costs previously capitalized. If the fees and costs previously capitalized are being amortized using the effective interest method, a new effective interest rate must be calculated based on the revised carrying amount and cash flows.
- 45-171. Sub-participation of a debt instrument by one creditor to other lenders does not affect the accounting treatment of the instrument by the debtor, unless the cash flows are also altered because the borrower's obligation to that creditor is not discharged. However, if the debt has been syndicated, and the borrower's obligations are to each syndicate member, it is possible that a renegotiation effectively creates more than one liability if individual syndicate members agree to different new terms.
- 45-172. In order to determine whether there has been a modification or exchange of debt instruments in transactions involving a third-party intermediary, it is necessary to determine whether the intermediary is acting as an agent or as a principal. If there is an agency relationship, the actions of the intermediary are viewed as those of the debtor (see paragraph 3856.A51).
- 45-173. The following examples are indicative, not definitive, and the enterprise may need to evaluate all aspects of the relationship with the intermediary:
- When the intermediary's role is restricted to placing or reacquiring debt for the debtor without placing its own funds at risk, the intermediary is an agent. When the intermediary places or reacquires debt for the debtor by committing its funds and is subject to the risk of loss of those funds, the intermediary is acting as principal.
 - When an intermediary places notes issued by the debtor, and the placement is done under a best-efforts agreement, the intermediary is acting as agent. Under a best-efforts agreement, an agent agrees to buy only those securities it is able to sell to others; if the agent is unable to remarket the debt, the issuer is obligated to pay off the debt. The intermediary may be acting as principal if the

placement is done on a firmly committed basis, which requires the intermediary to hold any debt it is unable to sell to others.

- When the debtor directs the intermediary and the intermediary cannot independently initiate an exchange or modification of the debt instrument, the intermediary is an agent. The intermediary may be a principal if it acquires debt from or exchanges debt with another debt holder in the market and suffers a loss as a result of the transaction.
- When the only compensation derived by an intermediary from its arrangement with the debtor is a pre-established fee, the intermediary is an agent. When the intermediary derives gains based on the value of the security issued by the debtor, the intermediary is a principal.

45-174. The following Application Example outlines scenarios where an investment banker acts as agent:

APPLICATION EXAMPLE	
	<p>Assuming all parties are unrelated, when a third-party investment banker acts as an agent on behalf of a debtor, its activities are treated as actions of the debtor. When an investment banker acquires debt instruments from holders for cash, the transaction is a settlement, even if the investment banker subsequently transfers a debt instrument with the same or different terms to the same or different investors.</p> <p>When an investment banker acquires debt instruments from holders for cash and contemporaneously issues new debt instruments for cash, a settlement has occurred only if the two debt instruments have substantially different terms, as defined above.</p> <p>In transactions involving a third-party investment banker acting as principal, the investment banker is considered a debt holder like other debt holders. Thus, if the investment banker acting as principal acquires debt instruments from other parties, the acquisition by the investment banker does not impact the accounting by the debtor. Exchanges or modifications between the debtor and the investment banker would follow the requirements discussed above.</p>

Modification of line of credit or other revolving debt arrangement

45-175. Paragraph 3856.A56 provides guidance to help determine whether changes to a revolving credit facility constitute replacement of one facility with another or a modification of the original instrument. Because future cash flows are not known, the extent of the modification is evaluated by comparing the capacity of the facility before and after the change. Capacity is estimated to be the product of the maximum available amount of the debt and the maximum term.

45-176. The following Application Example outlines the determination as to whether a new borrowing arrangement exceeds the capacity under the old arrangement, as well as the related accounting implications of fees and costs:

APPLICATION EXAMPLE



Terms of original revolving debt between unrelated parties:

- Five-year term (three years remaining)
- \$1 million commitment amount.

The borrowing capacity under the original arrangement at the time of the change was \$3 million, which equates to the product of the remaining term (three years) and the commitment amount (\$1 million).

The following changes were made (with the same creditor) to the original terms:

Scenario A: The commitment amount is increased to \$1.5 million and the term of the new arrangement remains at three years (borrowing capacity is \$4.5 million).

Scenario B: The commitment amount is decreased to \$200,000 and the term of the new arrangement is five and a half years (borrowing capacity is \$1.1 million).

Scenario C: The original revolver is replaced with a three-year \$750,000 term loan, with principal due at the end of three years (borrowing capacity is \$2.25 million).

Scenario D: The original revolver is replaced with a three-year \$1 million term loan, with principal due at the end of three years (borrowing capacity is \$3 million).

In all the scenarios, at the time the change is made to the original arrangement, \$15,000 of unamortized costs relating to the original arrangement remains on the debtor's balance sheet, the debtor pays a fee of \$10,000 to the creditor and the debtor also incurs third-party costs of \$20,000.

Scenario	Old borrowing capacity	New borrowing capacity	Accounting treatment of unamortized costs	Accounting treatment of fees and third-party costs incurred
A	\$3 million	\$4.5 million	\$15,000 is amortized over three years	\$30,000 is amortized over three years
B	\$3 million	\$1.1 million	Based on the ratio of new capacity to old capacity, 63% of the unamortized costs (\$9,500) are written off; the remaining costs (\$5,500) are amortized over 5.5 years	\$30,000 is amortized over 5.5 years

APPLICATION EXAMPLE					
	C	\$3 million	\$2.25 million	Based on the ratio of new capacity to old capacity, 25% of the unamortized costs (\$3,750) are written off; the remaining costs (\$11,250) are amortized over three years.	\$30,000 is amortized over three years
	D	\$3 million	\$3 million	\$15,000 is amortized over three years	\$30,000 is amortized over three years

Extinguishing financial liabilities with equity instruments

- 45-177. When a debtor settles all or part of a liability by issuing shares to its creditor in a “debt for equity swap”, the equity instruments are considered to be “consideration paid”. The equity instruments are measured at the more reliably measurable of the fair value of the equity or the fair value of the liability at the date of extinguishment. Any difference between the carrying amount of the financial liability (or part of the financial liability) extinguished or transferred and the consideration paid, including any non-cash assets transferred or liabilities assumed, is recognized in net income.
- 45-178. Fair value of the equity issued best reflects the total amount of consideration paid in the transaction, which may include a premium that the creditor requires to renegotiate the terms of the financial liability. However, when it is not practicable to determine the fair value of the shares issued, the fair value of the liability should be used. Debt for equity swaps often take place in situations where breaches of the terms of the financial liability have made the liability payable on demand. Paragraph 3856.A12 provides guidance on how to determine the fair value of liabilities payable on demand. However, this guidance is not applicable if the enterprise is unable to pay the debt.
- 45-179. When the issue of an entity's equity shares reflects consideration paid for both the extinguishment of part of a financial liability and the modification of the terms of the remaining part of the liability, the consideration paid should be allocated between the part of the liability extinguished and the part of the liability that remains outstanding. The entity would consider this allocation in determining the profit or loss to be recognized on the part of the liability extinguished in its assessment of whether the terms of the remaining liability have been substantially modified.

Convertible financial liabilities

- 45-180. The following table highlights considerations on extinguishment of a convertible financial liability issued or assumed in an arm's length transaction:


Extinguishment of a Convertible Financial Liability Issued or Assumed in an Arm's Length Transaction		
(Note: Convertible financial liabilities issued or assumed in a related party transaction, neither component is measured at fair value. The liability is measured in accordance with paragraph 3856.08(a), the undiscounted cash flows.)		
	When the conversion feature is initially measured at zero	When one or both components are measured at fair value
Consideration allocation	<p>The consideration paid is allocated to:</p> <ul style="list-style-type: none"> • the liability, up to its carrying amount, plus any accrued interest. • any residual amount is allocated to the equity component. (see paragraph 3856.A36(a)). 	<p>The consideration paid is allocated to:</p> <ul style="list-style-type: none"> • each component, on the same basis used for the original allocation of the proceeds received on issuance (see paragraph 3856.A36(b)).
Conversion is in accordance with the original terms (no cash)	<p>When the conversion option is exercised in accordance with the original terms of the instrument, the carrying amount of the equity element (i.e., the conversion feature), if any, plus the carrying amount of the liability element (including any accrued but unpaid interest) are transferred to share capital. No gain or loss is recognized (see paragraph 3856.A34).</p>	
Conversion is settled in cash	<p>When the conversion option is exercised and the issuer settles the obligation in cash, a gain or loss on extinguishment of the liability element is recognized in net income. The settlement of the equity element (i.e., the conversion feature) is treated as a capital transaction, 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 (see paragraph 3856.A35).</p>	
Conversion is not in accordance with the original terms (favourable conversion ratio)	<p>When the issuer offers a more favourable conversion ratio than that originally specified in the debt agreement or offers additional shares to entice the debt holder to convert by a specified time, the number of shares converted under the original terms is measured at the original contract price (as per the original conversion ratio), and any additional shares issued are measured at fair value. Any gain or loss recognized on the liability component is reflected in income, whereas any difference between the carrying amount and the amount considered to be settled on the conversion option is treated as a capital transaction (see paragraph 3856.A37).</p>	

Extinguishment of a Convertible Financial Liability Issued or Assumed in an Arm's Length Transaction

(Note: Convertible financial liabilities issued or assumed in a related party transaction, neither component is measured at fair value. The liability is measured in accordance with paragraph 3856.08(a), the undiscounted cash flows.)

Conversion option expires	The settlement is accounted for at its redemption value, which is also the stated principal amount of the instrument. The liability component is derecognized, and any carrying amount of the equity component is transferred to contributed surplus (see paragraph 3856.A38).
---------------------------	--

45-181. The following Application Example demonstrates the accounting for extinguishment of a compound financial instrument (assume all transactions are with unrelated parties):

APPLICATION EXAMPLE																								
	<p>Capital Corporation (Capital) needed to raise \$10,000 to fund its operations. As a result, it issued bonds in the aggregate amount of \$10,000, repayable in five years and carrying an annual interest rate of 6%. The bonds are convertible into a fixed number of common shares of Capital in the event of default on payment of the bond. The conversion feature was measured at \$250 using the Black-Scholes Model on initial issuance of the bond.</p>																							
	<p>Capital records the issuance of the bonds using one of the following alternatives:</p>																							
	<p>Conversion feature measured at zero</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;">Dr. Cash</td> <td style="width: 20%; text-align: right;">\$10,000</td> <td style="width: 30%;"></td> <td style="width: 20%;"></td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">Cr. Liability</td> <td style="text-align: right;">\$10,000</td> </tr> </table>	Dr. Cash	\$10,000					Cr. Liability	\$10,000	<p>Conversion feature measured at fair value</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;">Dr. Cash</td> <td style="width: 20%; text-align: right;">\$10,000</td> <td style="width: 30%;"></td> <td style="width: 20%;"></td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">Cr. Liability</td> <td style="text-align: right;">\$9,750</td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">Cr. Conversion feature</td> <td style="text-align: right;">250</td> </tr> </table>	Dr. Cash	\$10,000					Cr. Liability	\$9,750			Cr. Conversion feature	250		
Dr. Cash	\$10,000																							
		Cr. Liability	\$10,000																					
Dr. Cash	\$10,000																							
		Cr. Liability	\$9,750																					
		Cr. Conversion feature	250																					
<p>The following table illustrates the accounting treatment that would follow various different extinguishment scenarios (the illustrations assume all interest is paid as due):</p>																								
<p>Scenario</p>	<p>Conversion feature measured at zero</p>	<p>Conversion feature measured at fair value</p>																						
<p>Conversion in year three is in accordance with the original terms (no cash)</p>	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;">Dr. Liability</td> <td style="width: 20%; text-align: right;">\$10,000</td> <td style="width: 30%;"></td> <td style="width: 20%;"></td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">Cr. Share capital</td> <td style="text-align: right;">\$10,000</td> </tr> </table>	Dr. Liability	\$10,000					Cr. Share capital	\$10,000	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;">Dr. Liability**</td> <td style="width: 20%; text-align: right;">\$9,900</td> <td style="width: 30%;"></td> <td style="width: 20%;"></td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">Dr. Conversion feature</td> <td style="text-align: right;">250</td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">Cr. Share capital</td> <td style="text-align: right;">\$10,150</td> </tr> </table>	Dr. Liability**	\$9,900					Dr. Conversion feature	250			Cr. Share capital	\$10,150		
Dr. Liability	\$10,000																							
		Cr. Share capital	\$10,000																					
Dr. Liability**	\$9,900																							
		Dr. Conversion feature	250																					
		Cr. Share capital	\$10,150																					

APPLICATION EXAMPLE					
Conversion in year three is settled in cash	Dr. Liability	\$10,000	Dr. Liability	\$9,900	
	Cr. Cash		\$9,500	Dr. Conversion feature	250
	Cr. Gain	500	Cr. Cash		\$9,500
			Cr. Gain		634
			Cr. Contributed surplus		16
**Value of liability at year three					
To entice conversion in year three, Capital offers an additional 2,000 shares over and above the original fixed conversion ratio. The additional 2,000 shares have a fair value of \$2 each on issuance.					
Extinguishment not in accordance with the original terms (favourable conversion ratio)	Dr. Liability	\$10,000	Dr. Liability	\$9,900	
	Dr. Loss	4,000	Dr. Conversion feature		250
	Cr. Share capital	\$14,000	Dr. Inducement Expense		4,000
			Dr. Loss		100
			Cr. Share capital		\$14,250
Settlement upon expiry or maturity of conversion option and payment in cash	Dr. Liability	\$10,000	Dr. Liability	\$10,000	
	Cr. Cash	\$10,000	Cr. Cash		\$10,000
			Dr. Conversion feature		\$250
			Cr. Contributed surplus		\$250
Settlement upon expiry or maturity of conversion option and payment in shares	Dr. Liability	\$10,000	Dr. Liability	\$10,000	
	Cr. Share capital	\$10,000	Cr. Share capital		\$10,000
			Dr. Conversion feature		\$250
			Cr. Share Capital		\$250

HEDGE ACCOUNTING

- 45-182. Hedging is an activity intended to modify an entity's exposure to one or more risks. Hedging involves creating an offset to one or more characteristics of a contract or group of contracts with another contract. Many hedges occur naturally when features of a contract creating rights for the entity are offset by features of a contract creating obligations. For example, the foreign exchange risk created by selling goods or services in US dollars might be offset by purchases in US dollars. To the extent natural offsets do not occur within the entity's business model, an entity can use derivative contracts to create offsets. In another common example of hedging, an interest rate swap can be used to effectively convert floating rate debt to a fixed rate debt, making it easier to predict and manage cash flows.
- 45-183. Hedging does not reduce an entity's exposure to all risks, but rather mitigates some risk exposure by trading exposure to one risk for exposure to another. For example, consider a basic interest rate swap, effectively converting an entity's variable rate bank debt to a fixed rate debt. The entity has reduced its exposure to variability in periodic interest payments (i.e., a cash flow risk) in exchange for taking on additional price risk associated with the fair value of the swap. The entity is still exposed to risks associated with volatility in interest rates, but that exposure has been mitigated. With variable rate debt, the entity experiences an economic loss in the event interest rates (and therefore periodic interest payments) rise. After entering into the interest rate swap, the entity experiences an economic loss if interest rates decline (i.e., the entity has committed to pay a higher fixed rate of interest throughout the remaining term of the swap).
- 45-184. Two of the main advantages provided by hedging are:
1. the chance for an entity to reduce or eliminate exposure to those risks it considers less desirable in exchange for taking on additional exposure to one or more other risks it considers more acceptable
 2. the opportunity to reduce or eliminate uncertainty (e.g., by locking in interest rates or the domestic currency price for an anticipated foreign-currency-based commodity purchase).
- 45-185. Hedge accounting refers to a process whereby the normal accounting for the revenue or expense, gain or loss from a contract is modified to offset the timing of income recognition on another contract. Over the life of the contracts designated in a hedging relationship, the total amount of income is unchanged. Hedge accounting removes volatility from earnings that might be confusing to a financial statement user in situations where the entity has taken steps to pre-determine a desired economic result.
- 45-186. Section 3856 defines hedge accounting as follows:

Paragraph 3856.05(k) Hedge accounting is a method of recognizing the gains, losses, revenues and expenses associated with the items in a hedging relationship such that those gains, losses, revenues and expenses are

recognized in net income in the same period when they would otherwise be recognized in different periods.

45-187. It is important to note that hedge accounting is not required to be followed. An enterprise may enter into an interest rate swap or other hedging transaction and not use hedge accounting. In such case, the hedging item (e.g., the interest rate swap) would be accounted for separately as a stand-alone financial instrument.

45-188. Hedge accounting may be applied if certain conditions are specified:

Paragraph 3856.31 *A hedging relationship qualifies for hedge accounting only when all of the following conditions are satisfied:*

(a) *At the inception of the hedging relationship, the enterprise:*

(i) *designates that hedge accounting will be applied to the hedging relationship; and*

(ii) *formally documents the hedging relationship, identifying the hedged item, the related hedging item, the nature of the specific risk exposure or exposures being hedged and the intended term of the hedging relationship.*

(b) *Both at the inception of the hedging relationship and throughout its term, the enterprise has reasonable assurance that the critical terms of the hedging item and the hedged item are the same, as described in paragraphs 3856.A62-.A65 or paragraphs 1651.38-.41.*

(c) *When the hedged item is an anticipated transaction, it is probable the anticipated transaction will occur at the time and in the amount designated.*


A hedging transaction will not qualify for hedge accounting if it does not meet the above conditions. In that case, the hedging item will be accounted for separately as a stand-alone financial instrument.

45-189. Hedge accounting changes the normal accounting treatment of one or more components in a hedging relationship. The first condition indicated in paragraph 3856.31(a)(ii) states that hedge accounting must be designated and documented at the **inception** of the hedging relationship. This documentation must specify:

- the hedged item
- any related hedging item
- the nature of the specific risk exposure or exposures being hedged and
- the intended term of the hedging relationship.

45-190. To meet the condition in paragraph 3856.31(b), the entity must ensure it has reasonable assurance the critical terms of the hedging item and hedged item are the same, both at the inception of the relationship and throughout its term. Section 3856 defines the conditions that must be met to achieve the required degree of offset. These are discussed later in this chapter.

- 45-191. The last condition in paragraph 3856.31(c) addresses anticipated transactions. When an entity designates an anticipated transaction as the hedged item, it must be probable the transaction will occur in the amount and at the time expected. "Probable" should be interpreted as the term is normally used (i.e., more likely than not). However, the entity needs to be realistic about its expectations and should not designate marginally probable transactions.
- 45-192. It is important to understand that hedge accounting cannot be designated after the inception of the hedging instrument, as illustrated in the following Application Example:


APPLICATION EXAMPLE	
	Borrower Inc. issued \$500,000 of variable rate debt on January 1, 20X1. On July 1, 20X1, it entered into an interest rate swap to fix the interest rate at 4%. Economically, the debt was hedged from July 1, 20X1. In order to use hedge accounting, Borrower must designate that hedge accounting will be applied and document this on July 1. Hedge accounting can then be applied from July 1, 20X1, assuming the critical terms of the hedged item and the hedging item match. However, if this designation does not occur on July 1, 20X1, then Borrower cannot subsequently decide to apply hedge accounting.

Hedged Item

- 45-193. Section 3856 defines a hedging item as follows:

Paragraph 3856.05(I) A **hedged item** is a recognized asset, a recognized liability, an anticipated transaction or a net investment in a self-sustaining foreign operation having an identified risk exposure that an enterprise has taken steps to modify.

- 45-194. The following Application Example illustrates the identification of a hedged item:

APPLICATION EXAMPLE	
	Assume a company agrees to purchase machinery from a foreign supplier who requires payment in the supplier's own currency. The company risks that the exchange rate in effect when the company settles the payable will be less favourable than the rate in effect when the purchase decision was made. Management may therefore enter into a forward foreign exchange contract to buy the amount of foreign currency necessary to fix the price of the machine. The amount payable for the acquisition of the asset would be the hedged item.

- 45-195. More than one contract may be hedged by a single derivative contract as long as each transaction meets the requirements for hedge accounting and the aggregate amount of the designated contracts matches the amount of the hedging contract.

Hedging Item

- 45-196. Section 3856 defines a hedged item as follows:

Paragraph 3856.05(m) A hedging item is:

- (i) a derivative offsetting a risk exposure identified in the hedged item; or
- (ii) a non-derivative financial asset or a non-derivative financial liability offsetting the foreign currency risk exposure in the net investment in a self-sustaining foreign operation.

45-197. In the Application Example above, Borrower would designate the interest rate swap as the hedging item.

45-198. Section 3856 permits hedge accounting only for certain hedging relationships as noted in the following paragraph:

Paragraph 3856.32 *An enterprise may designate only the following hedging relationships:*

- (a) *an anticipated transaction denominated in a foreign currency hedged with a forward contract to mitigate the effect of changes in future foreign currency exchange rates (see paragraph 3856.A62);*
- (b) *an anticipated purchase or sale of a commodity hedged with a forward contract to mitigate the effect of future price changes of the commodity (see paragraphs 3856.A63-.A63C);*
- (c) *an interest-bearing asset or liability hedged with an interest rate swap to mitigate the effect of changes in interest rates (see paragraph 3856.A64);*
- (d) *a foreign currency denominated interest-bearing asset or liability hedged with a cross-currency interest rate swap to mitigate the effect of changes in interest rates and foreign currency exchange rates (see paragraph 3856.A65); and*
- (e) *the net investment in a self-sustaining foreign operation hedged with a derivative or non-derivative financial instrument to mitigate the effect of changes in foreign currency exchange rates (see FOREIGN CURRENCY TRANSLATION, paragraphs 1651.38-.41).*

45-199. The Basis for Conclusions provides additional clarification regarding the restriction of hedge accounting to only certain types of hedging relationships:

Basis for Conclusions Paragraph 107 Many Exposure Draft respondents thought the standard should permit hedge accounting for more complex relationships. Some requested the AcSB to permit the use of futures contracts as hedging instruments. The AcSB confirmed that special accounting for futures contracts and options used as hedging items would not be permitted. Futures contracts rarely match the critical terms of a contract perfectly due to their standardized quantities and settlement dates. An enterprise that hedges with futures contracts must account for those contracts at fair value. Although options can be effective in protecting an entity against unfavourable changes in a market price or rate, the AcSB was concerned that the accounting model that would be necessary to reflect such arrangements would unduly complicate the standard. In particular, certain types of options would provide too much flexibility to qualify as matching the critical terms of the hedged item. Some AcSB

members also noted that the asymmetrical hedging that occurs with options was inconsistent with the concept of neutralizing risk.

Accounting for the Hedging of Anticipated Transactions

- 45-200. Section 3856 provides guidance on the accounting treatment of hedges of anticipated transactions as follows:

Paragraph 3856.33 *An enterprise accounts for a qualifying hedge of an anticipated transaction as follows:*

- (a) *The hedged item is recognized initially at the amount of consideration payable or receivable. The gain or loss on the hedging item (forward contract, or the percentage of the contract relating to the hedged item) is recognized as an adjustment of the carrying amount of the hedged item when the anticipated transaction results in the recognition of an asset or a liability. When the hedged item is recognized directly in net income, the gain or loss on the hedging item is included in the same category of income or expense.*
- (b) *When the hedging item matures before the hedged item is recognized, the gain or loss on the hedging item (forward contract, or the percentage of the contract related to the hedged item) is recognized as a separate component of equity until the hedged item is recognized. When the hedged item is recognized, the gain or loss on the hedging item is transferred from the separate component of equity to the carrying amount of the hedged item or to net income in accordance with (a) (see paragraph 3856.A62A).*
- (c) *When the hedging item matures after the hedged item is recognized, the hedging item (forward contract, or the percentage of the contract related to the hedged item) is recognized on the same date as the hedged item using the spot price or rate in effect on that date (i.e., at an amount equal to the difference between the contract rate and the spot rate on the measurement date multiplied by the notional amount or quantity of the contract). The gain or loss is included in the carrying amount of the hedged item or in net income in accordance with (a), with the offsetting amount recognized as a derivative-related asset or liability, as appropriate. If a reporting period ends before the hedging item matures, the hedging item is remeasured using the spot price or rate in effect at the reporting period balance sheet date with any gain or loss included in net income. When the hedging item matures, the derivative-related asset or liability is derecognized, the hedging item is recognized at the settlement amount, and any additional gain or loss on the hedging item is recognized in net income.*

- 45-201. When a derivative qualifies as a hedge of an anticipated transaction, the derivative is not recognized on the balance sheet until the earlier of the date it matures or the date the anticipated transaction occurs. The following chart summarizes the guidance included in the above paragraph 3856.33:

Hedging an Anticipated Transaction	
Hedged item	Hedging item (i.e., forward contract)
If the hedging item (i.e., the forward contract) matures AT SAME TIME as the hedged item is recognized:	
When the anticipated transaction occurs, the hedged item is <i>recognized initially</i> at the amount of consideration payable or receivable.	<p>The hedging item (i.e., the forward contract) is not recognized until it matures.</p> <p>When the hedging item (i.e., the forward contract) matures, the gain or loss is recognized as an adjustment of the carrying amount of the hedged item when the anticipated transaction results in the recognition of an asset or a liability.</p> <p>When the hedged item is recognized directly in net income, the gain or loss on the hedging item is included in the same category of income or expense in the income statement.</p>
If the hedging item (i.e., the forward contract) matures BEFORE the hedged item is recognized:	
	<p>The gain or loss on the hedging item (i.e., the forward contract) is recognized as a separate component of equity until the hedged item is recognized.</p> <p>When the hedged item is recognized, the gain or loss on the hedging item (i.e., the forward contract) is transferred from the separate component of equity to the carrying amount of the hedged item or to net income, as appropriate.</p> <p>In the specific case of a foreign-currency-denominated anticipated purchase transaction hedged by a foreign exchange forward contract (i.e., the hedging item) settled gross by exchanging the two currencies, any foreign currency acquired on settlement of the forward contract is initially recognized at the spot rate in effect on the settlement date. While this foreign currency would not qualify as a hedge, Section 3856 does provide for some limited relief. When the foreign currency is held continuously between the date the forward contract is settled and the date the purchase transaction is recognized, any gain or loss on translating the foreign-currency cash held is presented as a separate component of equity until the purchase is recognized. When the purchase is recognized, the gain or loss on the foreign currency held is transferred from the separate component of equity to the carrying amount of the asset acquired in the purchase transaction or to net income, as appropriate.</p>

Hedging an Anticipated Transaction	
	This guidance is applicable to anticipated purchase transactions only and cannot be applied to hedges of anticipated sales transactions (see paragraph 3856.A62A).
If the hedging item (i.e., the forward contract) matures AFTER the hedged item is recognized:	
	<p>The hedging item (i.e., the forward contract) is recognized on the same date as the hedged item using the spot price or rate in effect on that date (i.e., at an amount equal to the difference between the contract rate and the spot rate on the measurement date multiplied by the notional amount or quantity of the contract).</p> <p>For example, assuming the relevant spot rate is 1.01, then a forward contract requiring an entity to purchase \$100 USD in 30 days' time at a rate of 1.04, is measured at \$3 ($[1.04 - 1.01] \times 100$) and recognized on the balance sheet as a derivative liability.</p> <p>The related gain or loss is included in the carrying amount of the hedged item or in net income. When the hedging item matures, the asset or liability is derecognized and any additional gain or loss on the forward contract is recognized in net income. The difference between the gain or loss recorded when the hedged item is recognized and the amount realized at the hedging item's maturity will offset the gain or loss on the receivable or payable resulting from the hedged item.</p>

Critical terms match

45-202. One of the conditions necessary to apply hedge accounting is that “both at the inception of the hedging relationship and throughout its term, the enterprise has reasonable assurance that the critical terms of the hedging item and the hedged item are the same” (paragraph 3856.31). This is logical, but if interpreted strictly, many hedging arrangements where there are minor differences in critical terms would not be eligible for hedge accounting. Section 3856 provides additional guidance on how to determine whether critical terms are the same.

45-203. The condition under which a foreign exchange forward contract can be designated as a hedge of an anticipated foreign currency transaction is clarified as follows:

Paragraph 3856.A62 An enterprise may designate a foreign exchange forward contract as a hedge of an anticipated foreign currency transaction or a group of foreign currency transactions only when:

- (a) the forward contract is for the purchase or sale of the same amount of the same currency as the designated hedged anticipated transaction or group of transactions;

- (b) the forward contract matures within 30 days of the settlement of each designated anticipated transaction;
- (c) it is probable the settlement of each anticipated foreign currency transaction will occur at the time and in the amount expected; and
- (d) the fair value of the forward contract at the inception of the hedging relationship is zero.

- 45-204. Paragraph 3856.A62A was added to clarify the treatment of hedging relationships using foreign exchange forward contracts that mature before the hedged item is recognized:

Paragraph 3856.A62A Foreign exchange forward contracts may be settled net by transferring the gain or loss amount, or gross by exchanging the two currencies. When a foreign exchange forward contract is designated as a hedge of an anticipated purchase transaction and the contract settles gross before the purchase is recognized, the foreign currency acquired on settlement of the contract is initially recognized at the spot rate in effect on the settlement date. When the foreign currency is held continuously between the date the contract is settled and the date the purchase transaction is recognized, any gain or loss on translating the foreign currency cash held is presented as a separate component of equity until the purchase is recognized. When the purchase is recognized, the gain or loss on the foreign currency held is transferred from the separate component of equity to the carrying amount of the asset acquired in the purchase transaction or to net income in accordance with paragraph 3856.33(a).

- 45-205. Section 3856 provides guidance on the conditions for concurrent hedging of commodity and foreign currency risks in an anticipated purchase or sale of a commodity in the following paragraphs:

Paragraph 3856.A63 An enterprise may designate a forward contract as a hedge of an anticipated purchase or sale of a commodity or a group of anticipated purchases and sales only when:

- (a) the commodity forward contract is for the purchase or sale of the same quantity and similar grade or purity of the same commodity as the designated hedged anticipated purchases or sales;
- (b) it is probable that each hedged anticipated purchase or sale will occur within 30 days of the maturity of the commodity forward contract;
- (c) it is probable that each anticipated commodity purchase or sale will occur at the time and in the amount expected; and
- (d) the fair value of the forward contract at the inception of the hedging relationship is zero.

Paragraph 3856.A63A In many circumstances, commodity transactions are undertaken in currencies other than that in which

an enterprise measures transactions for financial reporting purposes. An enterprise may decide to enter into a foreign exchange forward contract to mitigate the currency risk created by the following commodity hedging relationships:

- (a) an anticipated purchase or sale of a commodity denominated in the currency in which the enterprise measures transactions for financial reporting purposes hedged with a commodity forward contract denominated in a foreign currency;
- (b) an anticipated purchase or sale of a commodity denominated in a foreign currency hedged with a commodity forward contract denominated in the same foreign currency; and
- (c) an anticipated purchase or sale of a commodity denominated in a foreign currency hedged with a commodity forward contract denominated in the currency in which an enterprise measures transactions for financial reporting purposes.

Paragraph 3856.A63B When the hedged item (the anticipated purchase or sale of a commodity) is denominated in a foreign currency (the circumstances referred to in paragraph 3856.A63A(b) or (c)), a commodity forward contract may be designated as hedging the commodity price risk in the hedged item if it meets the conditions in paragraph 3856.A63. A foreign exchange forward contract may also be designated as hedging the currency risk in the anticipated purchase or sale in a separate hedging relationship provided it meets the conditions in paragraph 3856.A62.

Paragraph 3856.A63C When the hedged item (the anticipated purchase or sale of a commodity) is not denominated in a foreign currency and the commodity price risk is hedged with a commodity forward contract denominated in a foreign currency (paragraph 3856.A63A(a)), the commodity forward contract meeting the conditions in paragraph 3856.A63 may be designated as a hedge of the anticipated transaction in combination with a foreign exchange forward contract with the following terms:

- (a) the foreign exchange forward contract converts the same amount of the same currency as the commodity forward contract into the currency of the anticipated purchase or sale; and
- (b) the foreign exchange forward contract matures on the same day as the commodity forward contract.

45-206. The following Application Example illustrates the hedge of an anticipated purchase of a commodity:

APPLICATION EXAMPLE



Jules Jewels (JJ) is a successful jewellery designer and manufacturer located in Toronto. Its products are sold nationally in boutiques and major department stores. JJ has firm orders requiring approximately 1,000 ounces of pure gold to be manufactured in June and July 20X1. JJ committed its prices when the June 20X1 forward price of gold was US\$1,400 per ounce based on the Chicago Board of Trade June contract. JJ purchases gold alloys from a refiner who invoices at the spot price on the shipping date. Although these alloys are of differing purities, their prices vary directly with changes in the spot price of pure gold and JJ has calculated its 1,000-ounce requirement based on the purities of these alloys.

To ensure it achieves its target gross margin on its anticipated sales, JJ buys an over-the-counter cash-settled forward contract for 1,000 ounces of gold from a bank maturing on June 28 20X1, at US\$1,400 per ounce. JJ anticipates that all June and July purchases will take place within 30 days of the June 28 date. Because the Canadian dollar had been trading near par with the US dollar and expected to remain near par until these orders are produced and shipped, JJ initially decided against taking any action to ensure it is not affected by changes in the Canada-U.S. exchange rate.

Without hedge accounting, changes in the price of the forward contract would be recognized immediately in JJ's net income. JJ designates anticipated June and July inventory purchases equating to 1,000 ounces of gold as the hedged item, and the June 20X1 forward contract as the hedging item.

Currency Hedge

- 45-207. A hedge for a commodity can also hedge a currency risk encountered when neither the anticipated purchase nor sale of the hedging contract is denominated in the currency in which the entity measures its transactions for financial reporting purposes (see paragraph 3856.A63A to A63C above).
- 45-208. The following Application Example illustrates a foreign currency hedge of an anticipated purchase of a commodity (continued from the immediately preceding Application Example above):


APPLICATION EXAMPLE



In April 20X1, JJ becomes nervous that the near par relationship between the Canadian and US dollars will not continue through to the maturity of the forward contract. Accordingly, JJ purchases a forward foreign exchange contract to buy US\$1.4 million maturing on June 28, 20X1, and designates it as hedging the currency risk of its anticipated US-dollar-denominated gold purchases.

- 45-209. When hedging currency risk, the following conditions apply:
 - The amount and currency of the forward contract must match that of the anticipated transaction or group of transactions.
 - The forward contract must mature within 30 days of the settlement date of the anticipated transaction or transactions.

- It must be probable that each anticipated transaction will settle at the time and in the amount expected.
 - The fair value of the forward contract must be zero when designated.
- 45-210. Note that documentation of the hedging relationship also identifies the term of the relationship. In the Application Example above, the entity is hedging its anticipated purchases of gold and designates these purchases as the hedged item. Although the best economic protection occurs when the forward contract matures at the same time the payable will be settled, Section 3856 permits forward contracts maturing either before or after the expected settlement date of each anticipated transaction to be designated as the hedging item. This is discussed in greater detail below. The maximum period between the occurrence of the hedged item and the maturity of the hedging contract is 30 days.
- 45-211. The following Application Example illustrates scenarios of a hedge of anticipated foreign currency transactions:

APPLICATION EXAMPLE	
	<p><i>Scenario A</i></p> <p>Western Wire (WW) purchases inventory for US\$100,000 for delivery February 7. It intends to pay the account 30 days later on March 7. It designates a foreign exchange forward contract maturing on March 7 to purchase US\$100,000 for CAD\$105,000 as a hedge of the purchase. This relationship qualifies for hedge accounting because the designated amounts, currencies and dates exactly match.</p> <p><i>Scenario B</i></p> <p>Eastern Elements (EE) purchases inventory for US\$100,000 for delivery February 7. It intends to pay the account 30 days later on March 7. It designates a contract to purchase US\$100,000 for CAD\$105,000 on March 31 as a hedge of the purchase. This relationship qualifies for hedge accounting because the contract matures within 30 days of the settlement of the resulting account payable.</p> <p><i>Scenario C</i></p> <p>Central Connectors (CC) purchases inventory for US\$100,000 for delivery February 7. It intends to pay the account 60 days later on April 7th. It hedges the purchase with a foreign exchange forward contract maturing on April 15. This relationship qualifies for hedge accounting because the forward contract settles within 30 days of the settlement of the anticipated liability related to the inventory purchase.</p>

Hedge of interest rate risk

- 45-212. Interest rate swaps can be used to effectively convert either a floating rate asset or liability to a fixed rate or a fixed rate asset or liability to a floating rate. Hedge accounting may be designated when:
- the notional amount of the swap matches the principal amount of the interest-bearing asset or liability designated as the hedged item

- at the inception of the hedging relationship, the fair value of the swap is zero
- the formula for computing net settlements under the interest rate swap is the same for each net settlement. This means the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.
- it is probable the interest-bearing asset or liability will not be prepaid
- the index on which the variable leg of the swap is based matches the interest rate designated as the interest rate risk being hedged for that hedging relationship
- the swap matures within two weeks of the maturity date of the designated financial asset or liability
- there is no floor or ceiling on the variable interest rate of the swap
- in the case of a hedge of a fixed-rate asset or liability, the interval between repricing the variable interest rate in the swap is frequent enough (generally three to six months or less) to justify an assumption that the variable payment or receipt is at a market rate
- in the case of a hedge of a variable-rate asset or liability, the repricing dates are within two weeks of those of the variable rate asset or liability.

45-213. Section 3856 provides clarification on accounting for a hedge of an interest-bearing financial asset or financial liability with an interest rate swap:


Paragraph 3856.34 *An enterprise accounts for a qualifying hedge of an interest-bearing asset or liability as follows:*

(a) *Interest on the hedged item is recognized using the hedged item's stated interest rate plus or minus amortization of any initial premium or discount and any financing fees and transaction costs (see paragraphs 3856.A3-.A6).*

(b) *Net amounts receivable or payable on the hedging item (the interest rate swap or percentage of the interest rate swap designated as the hedging item) are recognized as an adjustment to interest on the hedged item in the period in which they accrue.*

(c) *When applicable, recognized foreign currency receivables and payables on a cross-currency interest rate swap hedging item are translated using current exchange rates with gains and losses included in net income in the period in which they arise.*

45-214. The following Application Example illustrates an interest rate swap:


APPLICATION EXAMPLE	
	<p>Southern Semiconductors (SS) borrows \$1 million repayable in three years, with interest floating at prime plus 5%, payable quarterly. SS does not have the ability to prepay the debt. SS simultaneously enters into a three-year interest rate swap with a notional amount of \$1 million to pay fixed at 4% and receives interest at the average prime rate. The combination of the interest rate swap and the debt obligation result in SS paying fixed interest at 9%.</p>

APPLICATION EXAMPLE	
	Both the debt obligation and the interest rate swap require payments to be made or received quarterly. The variable rate on the interest rate swap resets quarterly. SS designates the interest rate swap as a hedge of the floating rate debt obligation attributable to changes in the interest rates.

Cross-currency interest rate swap

- 45-215. All the requirements for designating an interest rate swap as a hedging instrument also apply to designating a cross-currency interest rate swap as a hedge of both the interest rate and currency risk of an interest-bearing asset or liability, with the following modifications:
1. When settlements of a cross-currency interest rate swap are not on a net basis, the formula for computing the gross settlement amounts is the same for each settlement. This means the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.
 2. The currency of one leg of the swap is the same as the currency in which the underlying hedged asset or liability is denominated, and the currency of the other leg of the swap is the same as the currency in which the reporting entity measures the underlying hedged asset or liability in its financial statements.
 3. When multiple swaps are used, the combined effect of all of the swaps must satisfy condition 2 above as for a single swap.

45-216. The following Application Example illustrates a cross-currency interest rate swap:

APPLICATION EXAMPLE	
	Northern Networks (NN) measures and reports in Canadian dollars. It agrees to finance an American customer's purchase of its product by extending a five-year US\$1 million loan at LIBOR + 3%. At the same time, it arranges a cross-currency interest rate swap that guarantees the Canadian dollar repayment of the loan and provides a fixed rate of return on the loan. NN designates the swap as a hedge of the currency and interest rate risk of the loan.

Hedge of the net investment in a self-sustaining foreign operation

- 45-217. FOREIGN CURRENCY TRANSLATION, Section 1651 permits an entity to designate all or a specified percentage of either a derivative or a non-derivative financial liability as a hedge of currency fluctuations created by translation of the net investment in a self-sustaining foreign operation, subject to all of the following conditions:
- The entity documents that hedge accounting will apply to the specified hedged and hedging items.
 - The currency in which the hedging item is denominated is the same as the currency in which the foreign operation measures its financial results.


- Foreign currency gains or losses on the hedging item are expected to offset foreign currency gains or losses on the hedged item throughout the term of the hedging relationship.

45-218. Remember, derivative contracts designated in a qualifying hedging relationship are exempt from the general requirement for derivatives to be subsequently measured at fair value following initial recognition. Thus, while foreign currency gains and losses on such derivative contracts may be expected to offset corresponding gains or losses on the net investment in a foreign operation, from a hedge accounting perspective, the gains or losses on the derivative are not reflected in the financial statements until the derivative matures. It is therefore important to consider both the nature and term of the hedging item carefully in advance to ensure the desired accounting result is achieved. Once exchange gains and losses on hedging items have been recognized, Section 1651 specifically provides that they be reported as an offset against the exchange gain or loss on the net investment in a separate component of shareholders' equity.

Illustrative Examples of Hedge Accounting

45-219. Applying hedge accounting under Section 3856 results in cash or accrual accounting for derivatives used to hedge financial assets and liabilities or anticipated transactions, such as expected purchases and sales. To qualify for hedge accounting, the key features of the derivative must be close enough to those of the item it hedges for the gain or loss on the derivative to offset the loss or gain on the hedged item. In most cases, rolling strategies may not be designated for hedge accounting because gains or losses on earlier contracts cannot be reinvested in subsequent contracts without altering the hedge ratio such that the amount of the forward contract matches the designated hedged item. This does not mean hedge strategies using rolling forwards do not reduce risk; however, Section 3856 is not designed to offer accounting relief for such hedging strategies.


45-220. The following Application Example illustrates the effect of hedge accounting on the purchase of a machine:

APPLICATION EXAMPLE							
	<p>Downward Developments (DD) purchases a machine January 2 to be delivered March 2, 20X1 for US\$100,000. On that date, the CAD/US exchange rate is 1.10. To minimize foreign currency risk exposure, management enters into a forward contract on that date to buy US\$100,000 on March 2 for CAD\$112,000. Entries are as follows:</p> <table border="0" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left; width: 50%;">Without hedge accounting</th> <th style="text-align: left; width: 50%;">With hedge accounting</th> </tr> </thead> <tbody> <tr> <td colspan="2" style="text-align: center;">January 2</td> </tr> <tr> <td>No entry required; the fair value of the forward contract at inception is \$0</td> <td>No entry</td> </tr> </tbody> </table>	Without hedge accounting	With hedge accounting	January 2		No entry required; the fair value of the forward contract at inception is \$0	No entry
Without hedge accounting	With hedge accounting						
January 2							
No entry required; the fair value of the forward contract at inception is \$0	No entry						

APPLICATION EXAMPLE			
January 31 (exchange rate = 1.05)			
Dr. Loss on forward (I/S)	\$7,000		No entry
Cr. Forward contract (B/S)		\$7,000	
To record fair value of forward contract (\$100,000 * (1.05 – 1.12))			
February 28 (exchange rate = 1.11)			
Dr. Forward contract (B/S)	\$7,000		No entry
Cr. Loss on forward (I/S)		\$7,000	
To reverse January entry			
Dr. Loss on forward (I/S)	\$1,000		No entry
Cr. Forward contract (B/S)		\$1,000	
To record fair value of forward contract (\$100,000 * (1.11 – 1.12))			
March 2 (exchange rate = 1.13)			
Dr. Forward contract (B/S)	\$1,000		No entry
Cr. Loss on forward (I/S)		\$1,000	
To reverse February entry			
Dr. Forward contract (B/S)	\$1,000		No entry
Cr. Gain on forward (I/S)		\$1,000	
To record fair value of forward contract (\$100,000 * (1.13 – 1.12))			
Dr. Machine	\$113,000	Dr. Machine	\$113,000
Cr. Accounts payable	\$113,000	Cr. Accounts payable	\$113,000
To record purchase of machine		To record purchase of machine	

APPLICATION EXAMPLE			
	Dr. Cash (CAD equivalent of US\$100,000 received)	\$113,000	
	Cr. Cash (CAD \$ paid)	\$112,000	
	Cr. Forward contract (B/S)	1,000	
	To record settlement of forward contract		
	Dr. Accounts payable	\$113,000	
	Cr. Cash	\$113,000	
	To record settlement of payable		
		Net effect	
		Balance sheet	
	Machine	\$113,000	Machine
			\$112,000
		Income statement	
	Foreign exchange gain (gain on forward contract)	\$1,000	No effect
	Without hedge accounting, DD will report a \$7,000 loss in January, which will subsequently reverse. This will cause volatility in DD's interim financial statements due to fluctuations in reported monthly net income.		


45-221. The following Application Example illustrates the effect of hedge accounting on the hedge of an anticipated foreign currency transaction:

APPLICATION EXAMPLE	
	<p><i>Scenario A</i></p> <p>Western Wire (WW) purchases inventory for US\$100,000 for delivery February 7. It intends to pay the account 30 days later on March 7. It designates a foreign exchange forward contract maturing March 7 to purchase US\$100,000 for CAD\$105,000 to hedge the purchase. This relationship qualifies for hedge accounting because the designated amounts, currencies and dates match.</p> <p>WW receives the inventory February 7 when the spot exchange rate is \$1 USD = \$0.98 CAD. The deemed value of the forward contract at that time is \$7,000. It settles the</p>

APPLICATION EXAMPLE			
payable March 7, when the spot exchange rate is \$1 USD = \$1.01 CAD. WW records the following journal entries:			
February 7			
Dr. Inventory	\$98,000		
Cr. Accounts payable (\$100,000 * .98)			\$98,000
Dr. Inventory	\$7,000		
Cr. Forward contract (FV)			\$7,000
To record receipt of the inventory			
March 7			
Dr. Accounts payable	\$98,000		
Dr. Foreign currency loss (\$101,000 – \$98,000)	3,000		
Cr. Cash (\$100,000 * 1.01)			\$101,000
Dr. Forward contract	\$7,000		
Dr. USD cash received in CAD \$ (\$100,000 * 1.01)	101,000		
Cr. Foreign exchange gain			\$3,000
Cr. CAD \$ cash paid (per forward contract)			105,000
To record settlement of the payable and the foreign exchange forward contract			
Summary: The inventory is recorded at \$105,000 and the entity does not record any foreign currency gain or loss.			
<i>Scenario B</i>			
Eastern Elements (EE) purchases inventory for US\$100,000 for delivery February 7. It intends to pay the account 30 days later on March 7. It designates a contract to purchase US\$100,000 for CAD\$105,000 on March 31 to hedge the purchase. This relationship qualifies for hedge accounting because the contract matures within 30 days of the settlement of the resulting payable.			
EE receives its inventory February 7 when the spot exchange rate is \$1 USD = \$0.98 CAD. EE settles the payable March 7, when the spot exchange rate is \$1 USD = \$1.01 CAD. The foreign exchange forward contract matures March 31, when the spot rate is \$1 USD = \$1.03 CAD. EE records the following entries:			
February 7			
Dr. Inventory	\$98,000		
Cr. Accounts payable (\$100,000 * .98)			\$98,000
Dr. Inventory	\$7,000		
Cr. Forward contract (FV)			\$7,000
To record receipt of the inventory			

APPLICATION EXAMPLE		
	March 7	
	Dr. Accounts payable	\$98,000
	Dr. Foreign currency loss	3,000
	Cr. Cash ($\$100,000 \times 1.01$)	\$101,000
	To record settlement of the payable	
	March 31	
	Dr. USD cash received in CAD \$ ($\$100,000 \times 1.03$)	\$103,000
	Dr. Forward contract	7,000
	Cr. CAD \$ cash paid (per forward contract)	\$105,000
	Cr. Foreign exchange gain	5,000
	To record settlement of the foreign exchange forward contract	
	Summary: The inventory is recorded at \$105,000. A net foreign exchange gain of \$2,000 is recorded, representing the ineffective portion arising from exchange rate fluctuations between settlement of the account payable and settlement of the forward contract.	


45-222. The following Application Example illustrates the hedge of an anticipated foreign currency transaction:

APPLICATION EXAMPLE			
	<i>Scenario C</i>		
	Mountain Movers (MM) purchased inventory for US\$100,000 for delivery May 3. It intended to pay for it 30 days later on June 3. It designated a contract maturing June 3 to purchase US\$100,000 for CAD\$103,000 as a hedge of the purchase. The goods were received May 3, when the spot exchange rate was \$1 USD = \$1.05 CAD. On June 3, the spot exchange rate was \$1 USD = \$1.04 CAD. MM records the following entries:		
	May 3		
		Dr. Inventory	\$105,000
		Cr. Accounts payable ($\$100,000 \times 1.05$)	\$105,000
		Dr. Forward contract (FV)	\$2,000
		Cr. Inventory	\$2,000
		To record receipt of the inventory	
		June 3	
		Dr. Accounts payable	\$105,000
	Cr. Cash ($\$100,000 \times 1.04$)	\$104,000	
	Cr. Foreign exchange gain	1,000	
	To record settlement of the payable		

APPLICATION EXAMPLE		
Dr. US cash received in CAD \$ ($\$100,000 * 1.04$)	\$104,000	
Dr. Foreign exchange loss	1,000	
Cr. CAD \$ cash paid (per forward contract)		\$103,000
Cr. Forward contract		2,000
To record settlement of the foreign exchange forward contract		
Summary: the inventory is recorded at \$103,000 and the entity records no foreign exchange gain or loss.		
<i>Scenario D</i>		
Prairie Planters (PP) purchased inventory for US\$100,000 for delivery May 3. It intended to pay the account 30 days later on June 3. PP designates a contract to purchase US\$100,000 for CAD\$103,000, maturing June 30 as a hedge of the purchase. The goods were received May 3, when the spot exchange rate was \$1 USD = \$1.05 CAD. On June 3, the spot exchange rate was \$1 USD = \$1.04 CAD. The exchange rate on June 30 when the forward contract matures was \$1 USD = \$1.06 CAD. PP records the following entries:		
May 3		
Dr. Inventory	\$105,000	
Cr. Accounts payable ($\$100,000 * 1.05$)		\$105,000
Dr. Forward contract (FV)	\$2,000	
Cr. Inventory		\$2,000
To record receipt of the inventory		
June 3		
Dr. Accounts payable	\$105,000	
Cr. Cash ($\$100,000 * 1.04$)		\$104,000
Cr. Foreign exchange gain		1,000
To record settlement of the payable		
June 30		
Dr. US cash received in CAD \$ ($\$100,000 * 1.06$)	\$106,000	
Cr. CAD \$ cash paid (per forward contract)		\$103,000
Cr. Forward contract		2,000
Cr. Foreign exchange gain		1,000
To record settlement of the foreign exchange forward contract		
Summary: The inventory is recorded at \$103,000 and a net foreign exchange gain of \$2,000 is recorded representing the ineffective portion arising from exchange rate		

APPLICATION EXAMPLE	
	fluctuations between settlement of the account payable and settlement of the forward contract.

45-223. The following Application Example illustrates a hedge of interest rate risk with an interest rate swap:

APPLICATION EXAMPLE																																																																					
	<p>Southern Semiconductors (SS) borrows \$1 million repayable in three years, with interest floating at prime plus 5%, payable quarterly. SS does not have the ability to prepay the debt. SS simultaneously enters into a three-year interest rate swap with a notional amount of \$1 million to pay fixed at 4% and receives interest at the average prime rate. The combination of the interest rate swap and the debt obligation results in SS paying fixed interest at 9%.</p> <p>Both the debt obligation and the interest rate swap require payments to be made or received quarterly. The variable rate on the interest rate swap resets quarterly. SS designates the interest rate swap as a hedge of the floating rate debt obligation attributable to changes in the interest rates. Average prime rates for each quarter are in the first column (below). For simplicity, interest is calculated as if each quarter contains an equal number of days (i.e., annual amount divided by 4).</p> <table style="margin-left: auto; margin-right: auto;"> <thead> <tr> <th colspan="4" style="text-align: center;">Year 1</th> </tr> </thead> <tbody> <tr> <td></td> <td style="padding-left: 20px;">Dr. Cash</td> <td style="text-align: right;">\$1,000,000</td> <td></td> </tr> <tr> <td></td> <td style="padding-left: 40px;">Cr. Loan payable</td> <td></td> <td style="text-align: right;">\$1,000,000</td> </tr> <tr> <td></td> <td colspan="3">To record receipt of the loan</td> </tr> <tr> <td style="vertical-align: top;">3%</td> <td style="padding-left: 20px;">Dr. Interest expense (loan payment)</td> <td style="text-align: right;">\$20,000</td> <td></td> </tr> <tr> <td></td> <td style="padding-left: 40px;">Cr. Cash</td> <td></td> <td style="text-align: right;">\$20,000</td> </tr> <tr> <td></td> <td style="padding-left: 20px;">Dr. Interest expense (swap payment)</td> <td style="text-align: right;">\$2,500</td> <td></td> </tr> <tr> <td></td> <td style="padding-left: 40px;">Cr. Cash</td> <td></td> <td style="text-align: right;">\$2,500</td> </tr> <tr> <td style="vertical-align: top;">3.5%</td> <td style="padding-left: 20px;">Dr. Interest expense (loan payment)</td> <td style="text-align: right;">\$21,250</td> <td></td> </tr> <tr> <td></td> <td style="padding-left: 40px;">Cr. Cash</td> <td></td> <td style="text-align: right;">\$21,250</td> </tr> <tr> <td></td> <td style="padding-left: 20px;">Dr. Interest expense (swap payment)</td> <td style="text-align: right;">\$1,250</td> <td></td> </tr> <tr> <td></td> <td style="padding-left: 40px;">Cr. Cash</td> <td></td> <td style="text-align: right;">\$1,250</td> </tr> <tr> <td style="vertical-align: top;">4%</td> <td style="padding-left: 20px;">Dr. Interest expense (loan payment)</td> <td style="text-align: right;">\$22,500</td> <td></td> </tr> <tr> <td></td> <td style="padding-left: 40px;">Cr. Cash</td> <td></td> <td style="text-align: right;">\$22,500</td> </tr> <tr> <td></td> <td colspan="3">No swap payment required – floating rate = fixed</td> </tr> <tr> <td style="vertical-align: top;">4.5%</td> <td style="padding-left: 20px;">Dr. Interest expense (loan payment)</td> <td style="text-align: right;">\$23,750</td> <td></td> </tr> <tr> <td></td> <td style="padding-left: 40px;">Cr. Cash</td> <td></td> <td style="text-align: right;">\$23,750</td> </tr> </tbody> </table>	Year 1					Dr. Cash	\$1,000,000			Cr. Loan payable		\$1,000,000		To record receipt of the loan			3%	Dr. Interest expense (loan payment)	\$20,000			Cr. Cash		\$20,000		Dr. Interest expense (swap payment)	\$2,500			Cr. Cash		\$2,500	3.5%	Dr. Interest expense (loan payment)	\$21,250			Cr. Cash		\$21,250		Dr. Interest expense (swap payment)	\$1,250			Cr. Cash		\$1,250	4%	Dr. Interest expense (loan payment)	\$22,500			Cr. Cash		\$22,500		No swap payment required – floating rate = fixed			4.5%	Dr. Interest expense (loan payment)	\$23,750			Cr. Cash		\$23,750
Year 1																																																																					
	Dr. Cash	\$1,000,000																																																																			
	Cr. Loan payable		\$1,000,000																																																																		
	To record receipt of the loan																																																																				
3%	Dr. Interest expense (loan payment)	\$20,000																																																																			
	Cr. Cash		\$20,000																																																																		
	Dr. Interest expense (swap payment)	\$2,500																																																																			
	Cr. Cash		\$2,500																																																																		
3.5%	Dr. Interest expense (loan payment)	\$21,250																																																																			
	Cr. Cash		\$21,250																																																																		
	Dr. Interest expense (swap payment)	\$1,250																																																																			
	Cr. Cash		\$1,250																																																																		
4%	Dr. Interest expense (loan payment)	\$22,500																																																																			
	Cr. Cash		\$22,500																																																																		
	No swap payment required – floating rate = fixed																																																																				
4.5%	Dr. Interest expense (loan payment)	\$23,750																																																																			
	Cr. Cash		\$23,750																																																																		

APPLICATION EXAMPLE			
		Dr. Cash	\$1,250
		Cr. Interest expense (swap payment received)	\$1,250
		Year 2	
5%		Dr. Interest expense (loan payment)	\$25,000
		Cr. Cash	\$25,000
		Dr. Cash	\$2,500
		Cr. Interest expense (swap payment received)	\$2,500
5.5%		Dr. Interest expense (loan payment)	\$26,250
		Cr. Cash	\$26,250
		Dr. Cash	\$3,750
		Cr. Interest expense (swap payment received)	\$3,750
6%		Dr. Interest expense (loan payment)	\$27,500
		Cr. Cash	\$27,500
		Dr. Cash	\$5,000
		Cr. Interest expense (swap payment received)	\$5,000
5%		Dr. Interest expense (loan payment)	\$25,000
		Cr. Cash	\$25,000
		Dr. Cash	\$2,500
		Cr. Interest expense (swap payment received)	\$2,500
		Year 3	
4%		Dr. Interest expense (loan payment)	\$22,500
		Cr. Cash	\$22,500
		No swap payment required – floating rate = fixed	
3%		Dr. Interest expense (loan payment)	\$20,000
		Cr. Cash	\$20,000
		Dr. Interest expense (swap payment)	\$2,500
		Cr. Cash	\$2,500
2.5%		Dr. Interest expense (loan payment)	\$18,750

APPLICATION EXAMPLE			
		Cr. Cash	\$18,750
		Dr. Interest expense (swap payment)	\$3,750
		Cr. Cash	\$3,750
3%		Dr. Interest expense (loan payment)	\$20,000
		Cr. Cash	\$20,000
		Dr. Interest expense (swap payment)	\$2,500
		Cr. Cash	\$2,500
		Dr. Loan payable	\$1,000,000
		Cr. Cash	\$1,000,000
		To record the repayment of loan	
		Summary: SS makes payments totaling \$272,500 to its lender but receives \$2,500 net from the swap counterparty over the life of the swap. The swap payments fix the effective interest rate on the loan at 9%.	

Discontinuance of Hedge Accounting

45-224. Section 3856 does not permit an entity to discontinue hedge accounting as a matter of choice. Paragraph 35 states when hedge accounting is to be discontinued:

Paragraph 3856.35 *An enterprise shall discontinue hedge accounting only when:*

- (a) *the hedged item or the hedging item ceases to exist other than as designated and documented;*
- (b) *the critical terms of the hedging item, as specified in paragraphs 3856.A62-.A65, cease to match those of the hedged item, including, but not limited to, when:*
 - (i) *it becomes probable that an interest bearing asset or liability hedged with an interest rate or cross currency interest rate swap will be prepaid; and*
 - (ii) *the hedged item is an anticipated transaction and it is no longer probable that the anticipated commodity purchase or sale transaction or the settlement of the anticipated foreign currency transaction will occur in the amount designated or within 30 days of the maturity date of the hedging forward contract.*

45-225. It should be noted that Section 3856 indicates the maximum number of days between a hedged transaction and the maturity of a hedging forward contract should be no more than 30 days. This guideline is relevant when initially deciding whether the hedge is effective. As noted above, it is also important for the assessment of whether hedge accounting should be discontinued.

45-226. An enterprise accounts for a discontinued hedging relationship as follows:

Paragraph 3856.36 Hedge accounting cannot be discontinued electively. A hedging relationship no longer meets the objective of hedge accounting if either the hedged item or the hedging item ceases to exist prior to the intended end date of the hedging relationship or if circumstances change such that the critical terms of the hedging item no longer match those of the hedged item. An enterprise accounts for a discontinued hedging relationship as follows:

(a) When a hedging item ceases to exist, any gains or losses incurred on its termination are recognized in net income at the same time the hedged item affects net income, as follows:

(i) When the hedged item is an anticipated transaction, any gain or loss incurred on the termination of the hedging item is recognized in a separate component of shareholders' equity. When the anticipated transaction occurs, the gain or loss is removed from shareholders' equity and is recognized as an adjustment of the carrying amount of the hedged item.

(ii) When the hedged item is a recognized asset or liability, any gain or loss incurred on the termination of the hedging item is recognized as an adjustment of the carrying amount of the hedged item.

(b) When:

(i) a hedged item ceases to exist;

(ii) the critical terms of the hedging item cease to match those of the hedged item;

(iii) it becomes probable that the interest-bearing hedged item will be prepaid; or

(iv) the hedged item is an anticipated transaction and it is no longer probable that an anticipated commodity purchase or sale transaction or the settlement of an anticipated foreign currency transaction will occur in the amount designated or within 30 days of the maturity date of the hedging item;

the hedging item is measured as otherwise required by this Section and any gain or loss is recognized in net income.

DISCLOSURE

45-227. This section of the chapter includes illustrations of notes that may meet the disclosure requirements of Section 3856. The examples in this section are illustrative only; notes should always reflect relevant facts and circumstances and meet the overall requirement for fair presentation detailed in GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, Section 1400. Specifically, paragraph 1400.04 provides the following guidance:

Paragraph 1400.04 A fair presentation in accordance with generally accepted accounting principles is achieved by:

(a) applying GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100;

- (b) providing sufficient information about transactions or events having an effect on the entity's financial position, results of operations and cash flows for the periods presented that are of such size, nature and incidence that their disclosure is necessary to understand that effect; and
- (c) providing information in a manner that is clear and understandable.

45-228. Section 3856 imposes minimum disclosure requirements on financial instruments (discussed further below). It is important to ensure that such disclosures are relevant and enterprise specific based on the entity's current risk exposure. Generic information that is not relevant or enterprise specific does not provide value-added information. Section 3856 states that disclosures should be sufficient to allow the evaluation of the significance of the financial instruments:

Paragraph 3856.37 *An enterprise shall disclose relevant enterprise specific information that enables users of its financial statements to evaluate the significance of financial instruments to its financial position and performance. Information is relevant and enterprise-specific when it is considered significant based on the enterprise's current exposure.*


Financial Assets

45-229. In addition to the general disclosure requirements, Section 3856 requires some specific disclosures. The carrying amount of the following categories of financial assets must be disclosed:

Paragraph 3856.38 *An enterprise shall disclose the carrying amounts of each of the following categories of financial instruments, either on the face of the balance sheet or in the notes:*

- (a) *financial assets measured at amortized cost;*
- (b) *financial assets measured at fair value; and*
- (c) *investments in equity instruments measured at cost less any reduction for impairment.*

45-230. The following Application Example illustrates disclosures for financial assets in the notes to the financial statements and the face of the balance sheet:

APPLICATION EXAMPLE	
	<p>Note X – Financial assets</p> <p>The classification and carrying amounts of the Company's financial assets, other than cash and accounts receivable, are as follows:</p>


APPLICATION EXAMPLE			
		December 31, 20X1	December 31, 20X0
	At amortized cost	\$17,500	\$12,500
	At cost	8,000	8,000
	At fair value	<u>4,100</u>	<u>3,600</u>
		\$29,600	\$24,100
		=====	=====
	-OR-		
	Note Y – Investments		
	The carrying amounts of the Company's investments are as follows:		
		December 31, 20X1	December 31, 20X0
	At amortized cost:		
	Rocky Bank of Canada Guaranteed Investment Certificates, two years, 2%, maturing June 30, 20X2	\$10,000	\$5,000
	Tele-Canada, three-year bond, 2.25%, maturing August 15, 20X3	<u>7,500</u>	<u>7,500</u>
		\$17,500	\$12,500
		=====	=====
	At cost:		
	10% interest in common shares of Private Company, Ltd.	\$8,000	\$8,000
	At fair value:		
	Portfolio of marketable securities	<u>4,100</u>	<u>3,600</u>
		\$29,600	\$24,100
		=====	=====

Accounts and notes receivable

45-231. The specific disclosure requirements for accounts and notes receivable are as follows:

Paragraph 3856.39 *Accounts and notes receivable shall be segregated so as to show separately trade accounts, amounts owing by related parties and other unusual items of significant amount. The amounts and, when practicable, maturity dates of accounts maturing beyond one year shall be disclosed separately.*

45-232. The following Application Example illustrates disclosure for accounts and notes receivable in the notes to the financial statements:

APPLICATION EXAMPLE			
	Note Z – Accounts and Notes Receivable		
		December 31, 20X1	December 31, 20X0
	Accounts receivable, trade	\$50,000	\$45,000
	Accounts receivable, trade, related parties*	25,000	26,000
	Government assistance receivable	5,000	4,500
	Notes receivable, employees, bearing interest at 4% per annum, repayable January 31, 20X5	8,000	8,500
	Notes receivable, directors, non-interest bearing, payable on demand	5,000	5,000
	Allowance for doubtful accounts (for trade receivables)	<u>(3,500)</u>	<u>(2,200)</u>
		\$90,500	\$86,800
	*Assumes the details on the related party and related party transactions are in a separate note.	=====	=====

APPLICATION EXAMPLE	
	<p>Section 1521, BALANCE SHEET, paragraph .04A indicates a government-assistance receivable must be separately presented either on the face of the balance sheet or in the notes to the financial statements, as illustrated above (see Chapter 11 of this <i>Guide</i>).</p> <p>Section 1510, CURRENT ASSETS AND CURRENT LIABILITIES, is also relevant and is discussed in Chapter 9 of this <i>Guide</i>.</p> <p>Paragraph 3856.42 provides an exception for the disclosure of current trade receivables. Typically for financial assets, an entity must disclose the carrying amount of impaired financial assets, by type of asset, and the amount of any related allowance for impairment. However, for current trade receivables, an entity can simply disclose the amount of any allowance for impairment as illustrated above. The disclosures for impairment of other financial assets are discussed later in this chapter.</p>

Transfers of receivables

- 45-233. The required disclosures for securitization activities are provided in the following paragraphs:


Paragraph 3856.40 *If an enterprise has transferred financial assets during the period and accounts for the transfer as a sale (see Appendix B), it shall disclose:*

- (a) *the gain or loss from all sales during the period;*
- (b) *the accounting policies for:*
 - (i) *initially measuring any retained interest (including the methodology used in determining its fair value); and*
 - (ii) *subsequently measuring the retained interest; and*
- (c) *a description of the transferor's continuing involvement with the transferred assets, including, but not limited to, servicing, recourse and restrictions on retained interests.*

Paragraph 3856.41 *If an enterprise has transferred financial assets in a way that does not qualify for derecognition (see Appendix B), it shall disclose:*

- (a) *the nature and carrying amount of the assets;*
- (b) *the nature of the risks and rewards of ownership to which the enterprise remains exposed; and*
- (c) *the carrying amount of the liabilities assumed in the transfer.*

- 45-234. The following Application Example illustrates disclosure related to sale/securitization of receivables:

APPLICATION EXAMPLE	
	<p>Note 1 – Summary of significant accounting policies</p> <p>Securizations</p> <p>To increase liquidity, the Company securitizes automobile loans, credit card loans and residential mortgage loans by selling them to an independent entity that issues securities to investors. It accounts for these transactions as sales when it transfers control of the assets for consideration other than a beneficial interest in the transferred assets. The Company may retain servicing rights or other retained interests in the securitized assets. Gains or losses on the sale of the assets depend on their previous carrying amounts and the allocation of those amounts between the portion sold and any retained interest based on their relative estimated fair values at the date of transfer. Quoted market prices are used to estimate fair values, if available. Because quotes are generally not available for retained interests, the Company estimates fair value based on the present value of future expected cash flows, calculated using management's best estimates of credit losses, prepayments, discount rates and other factors appropriate to the nature of the retained interest. Servicing assets are amortized in proportion to and over the period of estimated net servicing income.</p> <p>Note D – Sales of receivables</p> <p>During the year, the Company sold automobile loans, residential mortgage loans and credit card loans in securitization transactions. In all those securitizations, the Company retained servicing responsibilities and subordinated interests. The Company received annual servicing fees approximating 0.5% (for mortgage loans), 2.0% (for credit card loans) and 1.5% (for automobile loans) of the outstanding balance and rights to future cash flows arising after the investors in the securitization trust received the return for which they contracted. The investors and the securitization trusts have no recourse to the Company's other assets for failure of debtors to pay when due. The Company's retained interests are subordinate to investors' interests. Their value is subject to credit, prepayment and interest rate risks on the transferred receivables.</p> <p>In 20X1, the Company recognized pre-tax gains of \$2.23 million (20X0 – \$1.69 million) on the securitization of the automobile loans, \$3.02 million (20X0 – \$2.14 million) on the securitization of credit card loans and \$2.56 million (20X0 – \$1.5 million) on the securitization of residential mortgage loans.</p>


Impairment

- 45-235. Section 3856 requires the disclosure of the carrying amount of impaired assets, but specifically excludes this requirement for current trade receivables:

Paragraph 3856.42 *For financial assets other than current trade receivables, an enterprise shall disclose the carrying amount of impaired financial assets, by type of asset, and the amount of any related allowance for impairment. For current trade receivables*

(see CURRENT ASSETS AND LIABILITIES, Section 1510), *an entity shall disclose the amount of any allowance for impairment.*

- 45-236. The following Application Example illustrates the note disclosure for accounts receivable:

APPLICATION EXAMPLE	
	<p>Note L</p> <p>Accounts receivable are presented net of the allowance for doubtful accounts of \$3,500 (20X0 – \$2,200).</p>

Forgiveness

- 45-237. The disclosure requirements for forgiveness of a related party financial asset in net income is specified as follows:

Paragraph 3856.42A *If an enterprise recognizes the forgiveness of a related party financial asset in net income, as a result of applying the criteria in paragraph 3856.19AA(b)(ii), it shall disclose that fact and the nature of the transaction that gave rise to the financial asset.*

Financial Liabilities

- 45-238. The required disclosures for financial liabilities are provided in the following paragraphs:

Paragraph 3856.43 *For bonds, debentures and similar securities, mortgages and other long-term debt, an enterprise shall disclose:*

- (a) *the title or description of the liability;*
- (b) *the interest rate;*
- (c) *the maturity date;*
- (d) *the amount outstanding, separated between principal and accrued interest;*
- (e) *the currency in which the debt is payable if it is not repayable in the currency in which the enterprise measures items in its financial statements; and*
- (f) *the repayment terms, including the existence of sinking fund, redemption and conversion provisions.*

Paragraph 3856.44 *An enterprise shall disclose the carrying amount of any financial liabilities that are secured. An enterprise shall also disclose:*

- (a) *the carrying amount of assets it has pledged as collateral for liabilities; and*
- (b) *the terms and conditions relating to its pledge.*


Paragraph 3856.45 *An enterprise shall disclose the aggregate amount of payments estimated to be required in each of the next five years to meet repayment, sinking fund or retirement provisions of financial liabilities.*

Paragraph 3856.46 *For financial liabilities recognized at the balance sheet date, an enterprise shall disclose:*

(a) *whether any financial liabilities were in default or in breach of any term or covenant during the period that would permit a lender to demand accelerated repayment; and*

(b) *whether the default was remedied, or the terms of the liability were renegotiated, before the financial statements were completed.*

45-239. The following Application Example illustrates note disclosure for long-term debt:

APPLICATION EXAMPLE			
	Note M – Long-Term Debt		
		20X1	20X0
	Mortgage loan, principal repayable at \$600 monthly, plus interest at 4.25% compounded semi-annually, maturing May 31, 20X7, secured by land and building having an aggregate carrying amount of \$150,000	\$75,000	\$82,200
	Loan payable to shareholder, non-interest bearing, not due before January 1, 20X3	<u>25,000</u>	<u>26,000</u>
		\$100,000	\$108,200
		=====	=====
	Current portion	7,200	7,200
	Long-term portion	\$92,800	\$101,000
	The terms of the mortgage loan agreement require the Company to maintain specified working capital and debt-equity ratios. It also imposes restrictions on capital expenditures and distributions to shareholders. At the balance sheet date, the Company was not in conformity with the requirements of the mortgage loan agreement. The covenant violation provided the lender with the right to demand repayment of the full amount of the debt. However, subsequent to its year-end and prior to the completion of		

<p>the financial statements, the Company renegotiated the terms of its mortgage loan to ensure compliance with its covenants. Accordingly, the Company has continued to classify the mortgage loan as a long-term liability.</p> <p>Principal payments due in each of the next five years are as follows:</p>	
20X2	\$7,200
20X3	\$7,200
20X4	\$7,200
20X5	\$7,200
20X6	\$7,200

- 45-240. Section 3856 requires the following disclosures for a convertible instrument, indexed financial liability and ROMRS:

Paragraph 3856.47 *An enterprise that issues any of the following financial liabilities or equity instruments shall disclose information to enable users of the financial statements to understand the effects of features of the instrument, as follows:*

(a) *For a financial liability that contains both a liability and an equity element (see paragraph 3856.21), an enterprise shall disclose the following information about the equity element including, when relevant:*

- (i) *the exercise date or dates of the conversion option;*
- (ii) *the maturity or expiry date of the option;*
- (iii) *the conversion ratio or the strike price;*
- (iv) *conditions precedent to exercising the option; and*
- (v) *any other terms that could affect the exercise of the option, such as the existence of covenants that, if contravened, would alter the timing or price of the option.*

(b) *For a financial instrument that is indexed to the enterprise's equity or an identified factor, as described in paragraphs 3856.14 and 3856.14A, an enterprise shall disclose information that enables users of the financial statements to understand the nature, terms and effects of the indexing feature, the conditions under which a payment will be made and the expected timing of any payment.*

(ba) *for a related party financial instrument with variable or contingent payments as described in paragraph 3856.08D, an enterprise shall disclose information that enables users of the financial statements to understand the nature, terms and effects of the variable or contingent payments, the conditions under which a payment will be made and the expected timing of any payment.*

(c) *For retractable or mandatorily redeemable shares issued in a tax planning arrangement that are classified as equity as specified in paragraph 3856.23, an enterprise shall disclose:*

- (i) *on the face of the balance sheet, the total redemption amount for all classes of such shares outstanding;*

(ii) *the aggregate redemption amount for each class of such shares; and*


(iii) *a description of the arrangement that gave rise to the shares.*

(d) *In addition to the disclosure required for financial liabilities, for retractable or mandatorily redeemable shares issued in a tax planning arrangement that are classified as a financial liability, as specified in paragraph 3856.23, an enterprise shall disclose a description of the arrangement that gave rise to the shares.*


(e) *For retractable or mandatorily redeemable shares issued in a tax planning arrangement that are classified as a financial liability, when the effect of classifying these shares is recorded in retained earnings, an enterprise shall disclose on the face of the balance sheet, the amount charged to retained earnings for all classes of such shares.*

Note Disclosure for ROMRS

45-241. The following Application Example illustrates note disclosure for ROMRS classified as equity. In this scenario, Company CJ issued 1,000 ROMRS with a redemption amount of \$2 million pursuant to an estate freeze.


APPLICATION EXAMPLE	
	<p>Note L</p> <p>On January 15, 20X9, CJ Enterprises issued 1,000 redeemable preferred shares in an estate freeze, a tax-planning arrangement designed to effect the transfer of the business. The aggregate redemption amount of the redeemable preferred shares is \$2 million.</p> <p>The redeemable preferred shares may be redeemed on demand at the option of the holder.</p>

45-242. The following Application Example illustrates note disclosure for a convertible debenture:

APPLICATION EXAMPLE	
	<p>Note L</p> <p>During the year, the Company issued convertible debentures for \$100,000. These debentures bear interest at 5%, payable annually, and mature December 31, 20X6. The debenture holders have the option to convert the principal amount into common shares at a price of \$1,000 per share any time after March 31, 20X3.</p> <p>The Company's obligation to the convertible debenture holders has been recorded as a liability at the issuance proceeds amount of \$100,000. The conversion option has been allocated a value of \$0.</p> <p>-OR-</p>

APPLICATION EXAMPLE	
	<p>Note L</p> <p>During the year, the Company issued convertible debentures for \$100,000. These debentures bear interest at 5%, payable annually, and mature December 31, 20X6. The debenture holders have the option to convert the principal amount into common shares at a price of \$1,000 per share any time after March 31, 20X3.</p> <p>The Company's obligation to the convertible debenture holders has been recorded as a liability at its fair value of \$90,000. The conversion option has been recorded in equity at \$10,000, calculated as the difference between the consideration received and the fair value of the liability on the issue date.</p>

- 45-243. The following Application Example illustrates note disclosure for a loan payable indexed to equity:

APPLICATION EXAMPLE	
	<p>Note D</p> <p>The loan payable bears interest at 1.5 percentage points above the prime rate, payable monthly. Principal is repayable in annual installments of \$1,200 at the end of each year in which the Company's total equity exceeds \$2 million. The remaining principal is due December 31, 20X6.</p>

Derivatives

- 45-244. The required disclosures for derivatives are provided in the following paragraphs:

Paragraph 3856.48 *An enterprise shall disclose:*

- (a) *the notional and carrying amounts of all derivative assets measured at fair value;*
- (b) *the notional and carrying amounts of all derivative liabilities measured at fair value;*
- (c) *the method used to determine the fair value of all derivatives measured at fair value; and*
- (d) *the notional and accrued amounts of all interest rate and cross-currency interest rate swaps in designated hedging relationships.*


Paragraph 3856.49 *When an enterprise measures the fair value of a derivative asset or liability using a quote from a derivatives dealer, it discloses that fact and the nature and terms of the instrument.*

Paragraph 3856.50 *An enterprise shall disclose sufficient information about derivatives that are linked to, and must be settled by delivery of, equity instruments of another enterprise whose fair value cannot be readily determined (see paragraph 3856.12(b)(ii))*

to permit the reader to assess the potential implications of the contract. This information shall include:

- (a) the name of the issuer of the equity instrument;
- (b) a description of the equity instrument; and
- (c) the terms under which settlement will take place.

45-245. The following Application Example illustrates disclosure for various derivative financial instruments:

APPLICATION EXAMPLE	
	<p>Note K – Derivatives</p> <p>As at December 31, 20X1, the Company had foreign currency exchange contracts to sell US\$100,000 at the end of each month up to June 30, 20X2. These contracts are measured at fair value using quoted market rates. The aggregate carrying amount of these contract assets is \$9,350 at December 31, 20X1 (December 31, 20X0 – liability of \$3,700).</p> <p>The Company has an interest rate swap with a notional amount of \$500,000 maturing on September 30, 20X5. Under the terms of the swap, the Company pays fixed interest quarterly at 7% and receives the 90-day bankers' acceptance rate. At December 31, 20X1, the swap obligation has a carrying amount of \$17,230 and is owed to the Company's counterparty (December 31, 20X0 – asset of \$2,220).</p> <p>An interest rate swap with a notional amount of \$150,000 maturing on June 30, 20X2, is designated as a hedge of the Company's term loan maturing on the same day. Under the terms of the swap, the Company pays fixed interest monthly at 5% and receives the bank's prime rate plus three percentage points. The accrual at December 31, 20X1 is nil.</p>


Hedge Accounting

45-246. The disclosures required when an entity applies hedge accounting are as follows:


Paragraph 3856.51 *An enterprise that designates derivatives as hedging items shall disclose information that enables users of the financial statements to understand the effect of hedge accounting, as follows:*

- (a) *For a hedge of an anticipated transaction in accordance with paragraph 3856.33, during the term of the hedging relationship, the enterprise discloses the terms of the anticipated transaction including the nature and timing of the hedged item, the terms of the forward contract, the fact that hedge accounting applies and the net effect of the relationship.*
- (b) *For a hedge of an interest-bearing asset or liability in accordance with paragraph 3856.34, the enterprise discloses the nature and terms of the hedged item, the nature and terms of the hedging interest rate or cross-currency interest rate swap, the fact that hedge accounting applies and the net effect of the relationship.*

45-247. The following Application Example illustrates disclosure when an entity uses a forward contract to hedge future commodity purchases:

APPLICATION EXAMPLE					
	<p>Note H – Hedge accounting</p> <p>In November 20X1, the Company designated a wheat forward contract as a hedge of the price risk of its expected wheat purchases as follows:</p> <table border="0" style="width: 100%;"> <thead> <tr> <th style="text-align: left; width: 50%;">Hedged item</th> <th style="text-align: left; width: 50%;">Hedging item</th> </tr> </thead> <tbody> <tr> <td>Expected purchase of 500,000 bushels of wheat with expected March 20X2 delivery</td> <td>Forward contract to purchase 500,000 bushels of wheat at \$\$ for delivery March 20X2</td> </tr> </tbody> </table> <p>The effect of the hedge is to guarantee the price for the designated wheat purchase. Hedge accounting has been applied and the forward contract is not measured at fair value at December 31, 20X1.</p>	Hedged item	Hedging item	Expected purchase of 500,000 bushels of wheat with expected March 20X2 delivery	Forward contract to purchase 500,000 bushels of wheat at \$\$ for delivery March 20X2
Hedged item	Hedging item				
Expected purchase of 500,000 bushels of wheat with expected March 20X2 delivery	Forward contract to purchase 500,000 bushels of wheat at \$\$ for delivery March 20X2				

45-248. The following Application Example illustrates disclosure when an entity uses an interest rate swap to hedge interest rate risk:

APPLICATION EXAMPLE	
	<p>Note H – Derivatives – Interest Rate Swap</p> <p>An interest rate swap is designated as a hedge of the interest rate risk in the Company's five-year floating rate debt issue. The swap matures on the maturity date of the debt and requires the Company to pay fixed interest at 6%. The net effect of the swap is to convert the Company's floating rate debt to fixed rate debt to mitigate the Company's interest risk exposure and allow more reliable predictions of cash outflows. The floating rate side of the swap exactly matches the interest payments on the debt. Because all payments are due on the last day of each month, no amounts are accrued at the reporting date.</p>

Items of Income

45-249. The items of income related to financial instruments can be disclosed either on the face of the statements or in the notes to the financial statements as indicated in the following paragraphs:

Paragraph 3856.52 *An enterprise shall disclose the following items of income, expense, gains or losses either on the face of the statements or in the notes to the financial statements:*

- (a) *net gains or net losses recognized on financial instruments;*
- (b) *total interest income;*
- (c) *total interest expense on current financial liabilities;*
- (d) *interest expense on long-term financial liabilities, separately identifying amortization of premiums, discounts and financing fees; and*
- (e) *the amount of any impairment loss or reversal of a previously recognized loss.*

Paragraph 3856.19C *Income from investments subsequently measured at fair value or cost or using the cost method shall be separately presented on the face of the income statement.*

Risks and Uncertainties

45-250. Section 3856 requires disclosure of each significant risk arising from financial instruments. It is important to identify all risks, but disclosure should be limited to significant risks (considering the need to provide relevant, enterprise-specific information), including concentrations of risk, as noted in the following paragraphs:

Paragraph 3856.53 *For each significant risk (see paragraph 3856.A66) arising from financial instruments, including derivatives, an enterprise shall disclose:*

- (a) *the exposures to risk and how they arise; and*
- (b) *any change in risk exposures from the previous period.*

Paragraph 3856.53A An enterprise shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the enterprise is exposed at the end of the reporting period.

Paragraph 3856.54 *For each type of risk arising from financial instruments, an enterprise shall disclose concentrations of risk. Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions (see paragraph 3856.A67).*

45-251. Financial risks are described in Section 3856.A66 as follows:


Type of risk	Described in 3856.A66
Credit risk	Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
Currency risk	Currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
Interest rate risk	Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
Liquidity risk	Liquidity risk is the risk that an enterprise will encounter difficulty in meeting obligations associated with financial liabilities.
Market risk	Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.

Type of risk	Described in 3856.A66
Other price risk	Other price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

45-252. The following chart provides a sample format that can be used to identify the risks related to various types of financial instruments:

	Risks				
	Market risk				
Financial instrument	Credit	Liquidity	Currency	Interest rate	Other price
Cash and cash equivalents	X			X	
Accounts receivable	X		X		
Investments – Canadian				X	X
Investments – US Funds			X	X	X
Accounts payable and accrued liabilities		X	X		

45-253. As indicated in paragraph 3856.53, the significant risks related to financial instruments, including derivatives, must be separately disclosed. The following Application Example illustrates disclosure of risk related to oil-price changes and the use of derivatives to manage this risk:

APPLICATION EXAMPLE	
	<p>Note R – Risks and uncertainties</p> <p>The Company is exposed to the effect of changes in oil prices on its inventory purchases. This exposure to oil prices remains unchanged from the previous year. The Company uses over the counter and exchange-traded derivative contracts to mitigate some of this risk, but is unable to perfectly hedge its exposure. As at December 31, 20X1, the Company incurred losses due to oil price fluctuations of \$8,160 (December 31, 20X0 – gain of \$3,500).</p>

EFFECTIVE DATE AND TRANSITION

- 45-254. Section 3856 was effective for annual financial statements relating to fiscal years beginning on or after January 1, 2011, (earlier application was permitted) with one exception. The one exception was related to the designation of a hedging relationship, as indicated below:

Paragraph 3856.56 Notwithstanding the requirement in paragraph 3856.31(a) to designate and document all hedging relationships at inception, an enterprise may designate and document any hedging relationship that otherwise meets the requirements of this Section at any time prior to the end of the first fiscal year beginning on or after January 1, 2011.

- 45-255. Amendments to Section 3856 since its initial release have resulted in some new paragraphs with various effective dates, as summarized below:

Paragraph 3856.57 New paragraph 3856.19A, issued in October 2012, applies to annual financial statements relating to fiscal years beginning on or after January 1, 2013. Earlier application is permitted.

Paragraph 3856.58 Amendments to paragraphs 3856.03(k), and new paragraph 3856.A26A, issued in October 2013, apply to annual financial statements relating to fiscal years beginning on or after January 1, 2014. Earlier application is permitted.

Paragraph 3856.59 New paragraph 3856.A62A, issued in October 2013, applies to hedging relationships in effect at January 1, 2014. Earlier application to hedging relationships in effect on or after January 1, 2013 is permitted.

Paragraph 3856.60 Amendments to paragraphs 3856.03(a) and 3856.B25, issued in September 2014, apply to annual financial statements relating to fiscal years beginning on or after January 1, 2016. Earlier application is permitted.

Paragraph 3856.61 Amendments to paragraphs 3856.33(c) and 3856.42, issued in October 2014, apply to annual financial statements relating to fiscal years beginning on or after January 1, 2015. Earlier application is permitted.

- 45-256. Additional amendments to Section 3856 were issued in December 2018 and affect the accounting for financial instruments resulting from related party transactions and accounting for ROMRS. The effective date and transition provisions are noted below:

Paragraph 3856.62 The amendments to paragraphs 3856.23, 3856.47(c) and 3856.A29 and new paragraphs 3856.09A, 3856.15A, 3856.23A-.23H and 3856.47(d)-(e), issued in December 2018, apply to annual financial statements relating to fiscal years beginning on or after January 1, 2020. An enterprise applies these amendments as specified in paragraph 3856.63. Earlier application is permitted.

Paragraph 3856.63 Except as specified in paragraphs 3856.64-.65, an enterprise may choose to apply the amendments specified in paragraph 3856.62, either:

- (a) at the beginning of the earliest period presented; or
- (b) at the beginning of the fiscal year in which the amendments are first applied.

Paragraph 3856.63A When the amendments specified in paragraph 3856.62 are applied:

- (a) at the beginning of the earliest period presented, the cumulative effect of applying the amendments is recorded in opening retained earnings or a separate component of equity of the earliest period presented; or
- (b) at the beginning of the fiscal year in which the amendments are first applied, the cumulative effect of applying the amendments is recorded in opening retained earnings or a separate component of equity of the fiscal year in which the amendments are first applied.

Paragraph 3856.64 When the amendments are applied for the first time, an enterprise that issued retractable or mandatorily redeemable shares in a tax planning arrangement may choose to present the shares as:

- (a) a financial liability measured in accordance with paragraph 3856.09A; or
- (b) in a separate line in the equity section of the balance sheet if:
 - (i) the retractable or mandatorily redeemable shares were issued on or after January 1, 2018, and all the conditions in paragraph 3856.23 are met; or
 - (ii) the retractable or mandatorily redeemable shares were issued prior to January 1, 2018, and all the following conditions are met:
 - Control (see SUBSIDIARIES, Section 1591) of the enterprise that issued the retractable or mandatorily redeemable shares in a tax planning arrangement is held by the party that owns the shares in the arrangement at the date of initial application. The enterprise need not assess if control has been retained from the date of the initial transaction that gave rise to the shares.
 - No other written or oral arrangement exists such as a redemption schedule, that gives the holder of the shares the contractual right to require the enterprise to redeem the shares within a fixed or determinable period.

If both of the conditions above are not met for some or all of the retractable or mandatorily redeemable shares issued in a tax planning arrangement, those

shares are classified as a financial liability, and measured in accordance with paragraph 3856.09A.

Paragraph 3856.65 When an enterprise chooses to apply the amendments at the beginning of the earliest period presented, in accordance with paragraph 3856.63(a), the enterprise is not required to make retrospective adjustments in respect of retractable or mandatorily redeemable shares issued in a tax planning arrangement that were extinguished prior to the beginning of the fiscal year in which the amendments are first applied.

Paragraph 3856.66 Amendments to paragraphs 3856.04, 3856.07, 3856.07A, 3856.08, 3856.11, 3856.12, 3856.13, 3856.14, 3856.16, 3856.17, 3856.19C, 3856.22, 3856.27, 3856.28, 3856.29, 3856.37, 3856.47(b), 3856.53, 3856.A8, 3856.A30, 3856.A35-.A36, 3856.A37, 3856.A54, 3856.A56, 3856.A58, 3856.A59-.A60 and 3856.A61 and new paragraphs 3856.04A, 3856.05(ba)-.05(bb), 3856.05(da), 3856.05(ea), 3856.05(oa)-(od), 3856.08A-.08E, 3856.12A, 3856.13A-.13B, 3856.14A, 3856.17A-.17B, 3856.19AA, 3856.19B, 3856.22A, 3856.27A, 3856.28A-.28B, 3856.42A, 3856.47(ba), 3856.47A, 3856.53A, 3856.A7A, 3856.A8A-.A8K, 3856.A13A, 3856.A21A-.A21B, 3856.A37A-.A37C and 3856.A60A, issued in December 2018, apply to annual financial statements relating to fiscal years beginning on or after January 1, 2020. An enterprise applies these amendments as specified in paragraph 3856.67. Earlier application is permitted.

Paragraph 3856.67 Except as specified in paragraph 3856.68, an enterprise applies the amendments specified in paragraph 3856.66 retrospectively, in accordance with ACCOUNTING CHANGES, Section 1506.

Paragraph 3856.68 An enterprise applies the amendments as follows:

(a) for financial instruments originated or exchanged in a related party transaction that exist at the date these amendments are applied for the first time:

(i) the cost of a financial instrument that has repayment terms is determined using the undiscounted cash flow(s), excluding interest and dividend payments, of the instrument less any impairment measured in accordance with paragraph 3856.17A, as at the beginning of the earliest comparative period for the period which the amendments are applied for the first time;

(ii) the cost of a financial instrument that does not have repayment terms is deemed to be the carrying amount of the instrument in the financial statements of the enterprise less any impairment measured in accordance with paragraph 3856.17B, at the beginning of the earliest comparative period for the period which the amendments are applied for the first time; or

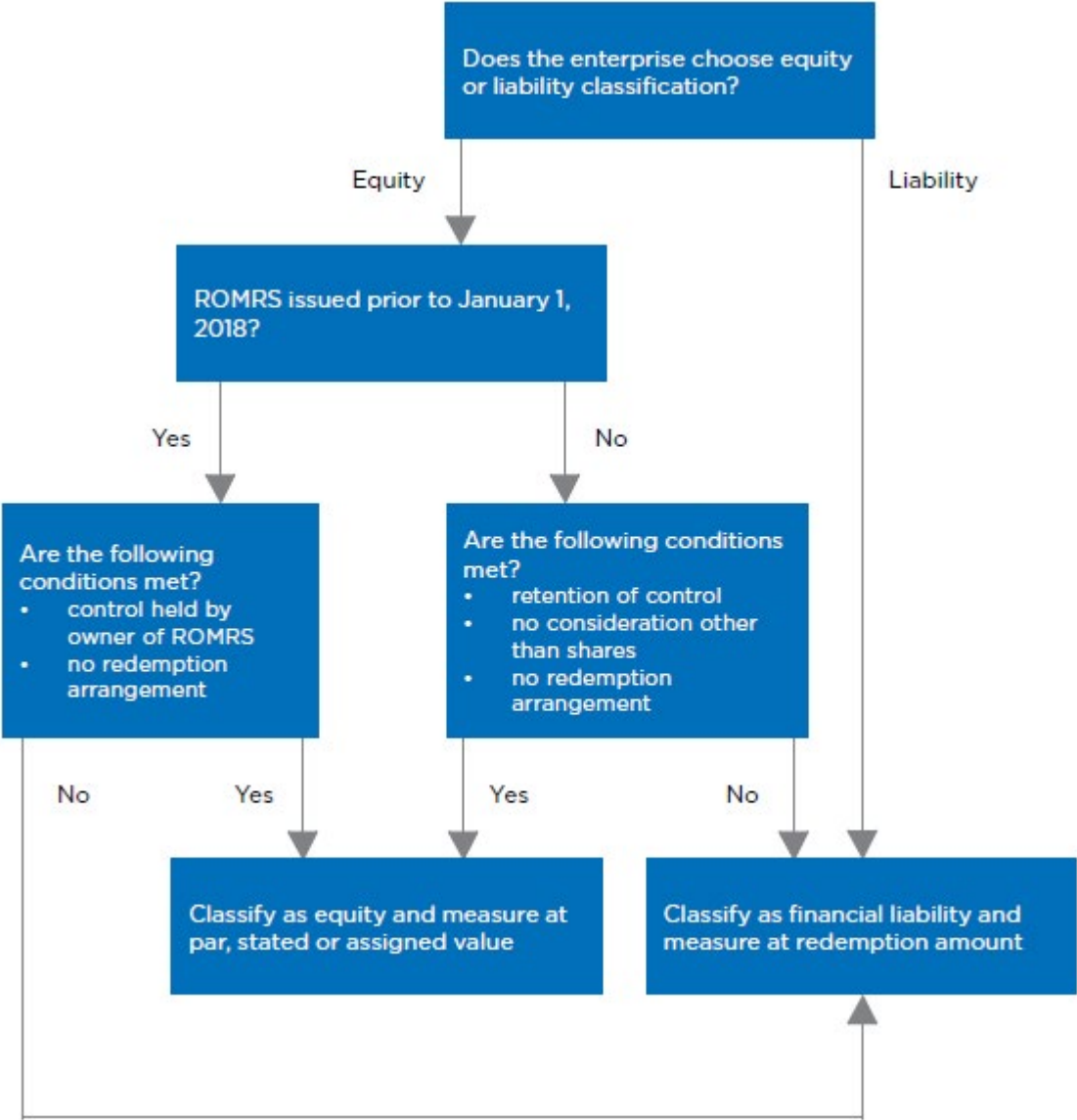
(iii) the fair value of a financial instrument that is an investment in debt or equity instruments that are quoted in an active market, a debt instrument where inputs significant to the determination of the fair value of the instrument are observable or a derivative contract is determined at the

beginning of the earliest comparative period for the period which the amendments are applied for the first time; and

(b) for financial instruments exchanged in a related party transaction that do not exist at the date these amendments are applied for the first time and were impaired or modified in the immediately preceding fiscal year, an enterprise need not restate the instrument as at the beginning of the earliest comparative period.


Transition for new Guidance on ROMRS

- 45-257. The guidance issued December 2018 is applicable for annual financial statements relating to fiscal years starting on or after January 1, 2020. There are no "grandfathering" provisions for existing ROMRS. An enterprise may choose to apply the new guidance in full retrospectively or at the beginning of the year adopted. On adoption, the cumulative effect is recorded in retained earnings (i.e., either in opening retained earnings or as a separate component of equity). When the amendments are applied, an enterprise may choose to recognize and measure the shares as liabilities (as set out in paragraph 3856.09A) or as equity, provided certain conditions are met.
- 45-258. If the ROMRS were issued on or after January 1, 2018 and all the conditions in paragraph 3856.23 have been met (i.e., control, exchange criteria, redemption schedule), then the shares can be treated as equity. If the ROMRS were issued prior to January 1, 2018, and both the redemption schedule criteria in paragraph 3856.23(c) and control of the enterprise is held by the party that owns the ROMRS on initial application, then the shares can be treated as equity. For clarity, an enterprise does not have to assess whether control has been retained from the date of the initial transaction that resulted in the ROMRS.
- 45-259. The following decision tree provides guidance on the transition to the new ROMRS amendments:



APPLICATION RESOURCES

- 45-260. The following Application Resources summarizes additional resources related to Section 3856:

APPLICATION RESOURCES	
	<p>Section 3856, Appendix B – Transfer of Receivables, provides detailed application guidance and examples on when an entity transfers receivables, specifically:</p> <ul style="list-style-type: none">• when the transfer includes the surrender of control and the transfer is accounted for as a sale• when the transfer does not qualify for derecognition. <p>Section 3856, Illustrative Examples, includes five examples related to the initial measurement of financial instruments in a related party transaction and for ROMRS issued in a tax planning arrangement as follows:</p> <p>Initial measurement of financial instruments in a related party transaction</p> <ul style="list-style-type: none">• Example 1 — Initial measurement of a loan between related parties• 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• Example 4 — Initial measurement of debt instruments issued between related parties <p>Retractable or mandatorily redeemable shares issued in a tax planning arrangement</p> <ul style="list-style-type: none">• Example 5 — Classification of retractable or mandatorily redeemable shares issued in tax planning arrangement <p><i>ASPE Briefing: Retractable or Mandatorily Redeemable Shares Issued in a Tax Planning Arrangement</i> https://www.cpacanada.ca/en/business-and-accounting-resources/financial-and-non-financial-reporting/accounting-standards-for-private-enterprises-aspe/publications/aspe-briefing-retractable-mandatorily-redeemable-shares</p> <p><i>ASPE Alert: Accounting for Related Party Financial Instruments and Significant Risk Disclosures</i> https://www.cpacanada.ca/en/business-and-accounting-resources/financial-and-non-financial-reporting/accounting-standards-for-private-enterprises-aspe/publications/aspe-alert-related-party-financial-instruments</p>

CURRENT DEVELOPMENTS

Recent Revisions


- 45-261. This chapter reflects the December 2018 amendments to Section 3856 effective for years beginning on or after January 1, 2020, to address the:
- accounting for related party financial instruments
 - disclosures related to significant risks
 - accounting for ROMRS issued in a tax planning arrangement and the exception to liability classification.

Projects and Discussions

- 45-262. There are no specific projects underway, but many discussions continue on this standard.
- 45-263. The AcSB is currently engaged in a research project to better understand the different types of related party combinations undertaken by private enterprises and not-for-profit organizations, which may have implications for this standard in the long term.
- 45-264. It is always useful to review projects completed, projects in progress and the minutes of meeting from the Private Enterprise Advisory Committee.

APPENDIX A – DEFINITIONS

45A-1 The chart below contains a list of definitions included in paragraph 3856.05:

DEFINITIONS		
	Amortized cost	Amortized cost is the amount at which a financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment (see paragraphs 3856.A3-.A6).
	Anticipated transaction	An anticipated transaction is any transaction expected to occur in the future that has not yet given rise to a recognized asset or liability.
	Carrying amount	For the purposes of applying paragraph 3856.08B, 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.
	Cost method	The cost method is a basis of accounting for financial instruments whereby the instrument is initially recorded at cost; earnings from such instruments are recognized only to the extent received or receivable.
	Derecognition	Derecognition is the removal of a previously recognized financial asset or financial liability from an enterprise's balance sheet.
	Derivative	A derivative is a contract with all three of the following characteristics: <ul style="list-style-type: none"> (i) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or other variable (sometimes called the "underlying"), provided in the case of a non-financial variable that the variable is not specific to a party to the contract; (ii) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and (iii) it is settled at a future date.

DEFINITIONS		
	Economic interest	An economic interest in another not-for-profit organization exists if: (i) the other organization holds resources that must be used to produce revenue or provide services for the reporting organization; or (ii) the reporting organization is responsible for the liabilities of the other organization.
	Equity instrument	An equity instrument is any contract that evidences a residual interest in the assets of an enterprise after deducting all of its liabilities.
	Exchange amount	Exchange amount is the amount of consideration paid or received as established and agreed to by related parties.
	Fair value	Fair value is the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. (Paragraph 3856.A7 provides related application guidance.)
	Financing fees	Financing fees are amounts that compensate the lender for the risk of providing funds to the borrower. Financing fees, sometimes referred to as fees in lieu of interest, loan fees or financing costs, include: (i) fees charged to originate, arrange or syndicate a loan or debt financing; (ii) commitment, standby and guarantee fees; and (iii) refinancing, restructuring and renegotiation fees. Financing fees may be refundable or non-refundable. Financing fees do not include transaction costs.
	Financial asset	A financial asset is any asset that is: (i) cash; (ii) a contractual right to receive cash or another financial asset from another party; (iii) a contractual right to exchange financial instruments with another party under conditions that are potentially favourable; or (iv) an equity instrument of another enterprise. The cost incurred by an enterprise to purchase a right to reacquire its own equity instruments from another party is a deduction from its equity, not a financial asset.
	Financial instrument	A financial instrument is a contract that creates a financial asset for one enterprise and a financial liability or equity instrument of another enterprise.

DEFINITIONS		
	Financial liability	A financial liability is any liability that is a contractual obligation: <ul style="list-style-type: none"> (i) to deliver cash or another financial asset to another party; or (ii) to exchange financial instruments with another party under conditions that are potentially unfavourable to the enterprise.
	Hedge accounting	Hedge accounting is a method of recognizing the gains, losses, revenues and expenses associated with the items in a hedging relationship such that those gains, losses, revenues and expenses are recognized in net income in the same period when they would otherwise be recognized in different periods.
	Hedged item	A hedged item is a recognized asset, a recognized liability, an anticipated transaction or a net investment in a self-sustaining foreign operation having an identified risk exposure that an enterprise has taken steps to modify.
	Hedging item	A hedging item is: <ul style="list-style-type: none"> (i) a derivative offsetting a risk exposure identified in the hedged item; or (ii) a non-derivative financial asset or a non-derivative financial liability offsetting the foreign currency risk exposure in the net investment in a self-sustaining foreign operation.
	Hedging relationship	A hedging relationship is a relationship established by an enterprise's management between a hedged item and a hedging item that satisfies all of the conditions in this Section.
	Insurance contract	An insurance contract is a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. Insurance contracts include any contract based on climatic, geological or other physical variables.
	Observable inputs	Observable inputs are developed using market data, such as publicly available information about actual events or transactions, and reflect the assumptions that knowledgeable, willing parties that are under no compulsion to act would use when valuing the asset or liability. Examples of markets in which inputs might be observable for financial assets or financial liabilities include exchange markets, dealer markets, brokered

DEFINITIONS		
		markets and principal-to-principal markets.
	Related parties	<p>Related parties exist when one party has the ability to exercise, directly or indirectly, control, joint control or significant influence over the other.</p> <p>Two or more parties are related when they are subject to common control, joint control or common significant influence. Two not-for-profit organizations are related parties if one has an economic interest in the other. Related parties also include management and immediate family members (see RELATED PARTY TRANSACTIONS, paragraph 3840.04 or DISCLOSURE OF RELATED PARTY TRANSACTIONS BY NOT-FOR-PROFIT ORGANIZATIONS, paragraph 4460.04 in Part III of the Handbook, as applicable).</p>
	Related party financial instrument	A related party financial instrument is a contract between related parties that creates a financial asset for one enterprise and a financial liability or equity instrument of another enterprise.
	Related party transaction	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.
	Transaction costs	Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the enterprise had not acquired, issued or disposed of the financial instrument. Transaction costs include expenditures such as legal fees, reimbursement of the lender's administrative costs and appraisal costs associated with a loan. Transaction costs do not include financing fees, debt premiums or discounts.

APPENDIX B – FAIR VALUE

45B-1 Fair value is defined in paragraph 3856.05(f) as follows:

Fair value is the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

45B-2 In practice, this definition can be difficult to apply. In determining fair value for a particular financial instrument, the following considerations may be applicable:


- Fair value measurement presumes the going concern assumption applies. This means fair value is not an amount an entity would pay in a forced transaction, involuntary liquidation or distressed sale.
- Fair value reflects the credit quality of the instrument, including any collateral or other credit enhancements.
- Quoted prices in an active market are the best evidence of fair value so long as they reflect actual and regularly occurring market transactions on an arm's length basis, which will be the case when prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency.
- When current rates or prices are unavailable, the price of the most recent transaction may provide evidence of the current fair value after considering whether there have been any significant changes that might affect fair value since the time the most recent transaction took place.
- In the absence of a recent transaction for the instrument being measured, fair value may be based on a recent price for a similar proxy instrument that has similar characteristics.
- In some cases, it may be prudent to consider engaging the use of a specialist or valuator in determining fair value.

45B-3 The following chart provides examples of fair value sources by instrument:


Instrument	Fair value or proxy
Equity instrument quoted in an active market	<ul style="list-style-type: none"> • latest closing price
Non-option derivatives	<ul style="list-style-type: none"> • mid-market prices or rates consistent with prices that would be supplied by banks • quote from a derivatives dealer
Option derivatives	<ul style="list-style-type: none"> • bid prices for purchased options and ask prices for issued options (mid-market prices may be used)

Instrument	Fair value or proxy
	<ul style="list-style-type: none"> • quote from a derivatives dealer • software packages
Interest-free or low interest loans	<ul style="list-style-type: none"> • present value of all future cash receipts discounted using the prevailing market rates of interest for a similar instrument (as to currency, term, type of interest rate, or other relevant factors) with a similar credit rating

45B-4 The following Application Example shows the calculation of fair value of a low interest receivable:

APPLICATION EXAMPLE																									
	<p>Seller sells a machine to an unrelated party for \$1,000, payable in three years at 3% interest. The market rate of interest is 5%. The fair value of the receivable on the books of Seller and corresponding journal entry to record the transaction are as follows:</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Interest of \$30 due in one year</td> <td style="text-align: right;">\$ 29</td> <td></td> </tr> <tr> <td>Interest of \$30 due in two years</td> <td style="text-align: right;">\$ 27</td> <td></td> </tr> <tr> <td>Interest of \$30 due in three years</td> <td style="text-align: right;">\$ 26</td> <td></td> </tr> <tr> <td>Principal of \$1000 due in three years</td> <td style="text-align: right;"><u>\$864</u></td> <td></td> </tr> <tr> <td>Fair value</td> <td style="text-align: right;">\$946</td> <td></td> </tr> <tr> <td colspan="3" style="padding: 10px 0 0 40px;"> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 40%;">Dr. Receivable</td> <td style="text-align: right;">\$946</td> <td></td> </tr> <tr> <td style="padding-left: 20px;">Cr. Sales revenue</td> <td></td> <td style="text-align: right;">\$946</td> </tr> </table> </td> </tr> </table>	Interest of \$30 due in one year	\$ 29		Interest of \$30 due in two years	\$ 27		Interest of \$30 due in three years	\$ 26		Principal of \$1000 due in three years	<u>\$864</u>		Fair value	\$946		<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 40%;">Dr. Receivable</td> <td style="text-align: right;">\$946</td> <td></td> </tr> <tr> <td style="padding-left: 20px;">Cr. Sales revenue</td> <td></td> <td style="text-align: right;">\$946</td> </tr> </table>			Dr. Receivable	\$946		Cr. Sales revenue		\$946
Interest of \$30 due in one year	\$ 29																								
Interest of \$30 due in two years	\$ 27																								
Interest of \$30 due in three years	\$ 26																								
Principal of \$1000 due in three years	<u>\$864</u>																								
Fair value	\$946																								
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 40%;">Dr. Receivable</td> <td style="text-align: right;">\$946</td> <td></td> </tr> <tr> <td style="padding-left: 20px;">Cr. Sales revenue</td> <td></td> <td style="text-align: right;">\$946</td> </tr> </table>			Dr. Receivable	\$946		Cr. Sales revenue		\$946																	
Dr. Receivable	\$946																								
Cr. Sales revenue		\$946																							

45B-5 The following Application Example shows a change in fair value of a forward contract:

APPLICATION EXAMPLE															
	<p>ABC Corporation (ABC) purchased a forward contract on January 15, 20X1 to purchase US\$100,000 August 1, 20X1 at a rate of 1.045. ABC will receive US\$100,000 in exchange for CAD\$104,500 August 1, 20X1. The spot rate on January 15, 20X1 was 1.05.</p> <p>On March 31, 20X1, ABC's year-end, the forward rates for US dollars are as follows:</p> <table style="width: 100%; border-collapse: collapse; margin: 10px 0;"> <thead> <tr> <th style="width: 15%;"></th> <th style="width: 10%;">1-Month</th> <th style="width: 10%;">2-Months</th> <th style="width: 10%;">3-Months</th> <th style="width: 10%;">4-Months</th> <th style="width: 10%;">5-Months</th> <th style="width: 10%;">6-Months</th> </tr> </thead> <tbody> <tr> <td>Forward rate</td> <td style="text-align: center;">1.049</td> <td style="text-align: center;">1.048</td> <td style="text-align: center;">1.046</td> <td style="text-align: center;">1.047</td> <td style="text-align: center;">1.046</td> <td style="text-align: center;">1.045</td> </tr> </tbody> </table> <p>Assume the change in fair value of the forward contract is calculated as follows: Foreign currency forward contract * (contract rate – contract rate in effect at the period end)</p>		1-Month	2-Months	3-Months	4-Months	5-Months	6-Months	Forward rate	1.049	1.048	1.046	1.047	1.046	1.045
	1-Month	2-Months	3-Months	4-Months	5-Months	6-Months									
Forward rate	1.049	1.048	1.046	1.047	1.046	1.045									

APPLICATION EXAMPLE

Using the formula above, the change in fair value of the forward contract is:
 $\$100,000 * (1.047 \text{ forward rate in four months' time} - 1.045 \text{ contracted rate}) = \$200.$

The following journal entry records the change in fair value of the forward contract:

Dr. Derivative asset	\$200	
Cr. Unrealized gain on derivative (net income)		\$200

45B-6 The following Application Example shows the calculation of the change in fair value of an interest-rate swap:

APPLICATION EXAMPLE



On January 1, 20X1, Coverage Corporation borrowed \$5 million repayable in five years at prime plus 1.5 basis points. On June 1, 20X1, Coverage Corporation decides to enter into an interest rate swap to minimize its exposure to fluctuations in the prime rate.

Under the swap's terms, Bank of Lenders pays Coverage Corporation prime plus 1.5 basis points and Coverage Corporation pays Bank of Lenders 3.5% fixed for the remaining term of the loan.

If Coverage Corporation does not want to apply hedge accounting, Coverage Corporation is required to measure the swap at fair value at each reporting period. The fair value of the swap can be estimated with the use of commercially available software and prices or by requesting an approximate fair value of the swap from Bank of Lenders.

To verify whether the estimate received from the bank is reasonable, the following technique can be used:

Notional amount	\$5,000,000
Number of months remaining in swap agreement	54 months
Prime rate:	
Current	1.30%
Expected average – High end of range	3.80%
Expected average – Low end of range	3.30%
Interest rate of the debt	
Variable	2.80%
Interest rate of the swap	
Fixed	3.50%
Discount rate – risk-free rate based on remaining term swap	2.00%
Discounted cash flows – High / Low estimate	

APPLICATION EXAMPLE	
High	
Fixed rate	$\$5,000,000 * 3.50\% = \$(175,000)$
Variable	$\$5,000,000 * 3.80\% = \$190,000$
Difference per year	\$15,000
Difference per month	\$1,250
Present value of future cash flows (PV of \$1,250 for 54 months, using 2%) (PV, n = 54, i = .0017, D = 1,250 = \$64,442; say \$64,500)	\$64,500
Low	
Fixed rate	$\$5,000,000 * 3.50\% = \$(175,000)$
Variable	$\$5,000,000 * 3.30\% = \$165,000$
Difference per year	\$(10,000)
Difference per month	\$(833)
Present value of future cash flows (PV of \$1,250 for 54 months, using 2%) (PV with n = 54, i = .0017, D = -833 = \$42,944; say \$43,000)	\$(43,000)
External valuation	
Mark-to-market from bank	\$52,000
Conclusion: Because the bank's valuation is within the high/low range, the value provided by the bank is reasonable.	
Note: If the swap value is material to the overall financial statements, a more precise technique should be considered to estimate the reliability of the bank's estimate, such as determining points along the interest rate curve over the remaining term of the swap.	