Understanding ASPE
Section 3856, Financial Instruments
Seven questions for private business owners: Financial Instruments

A better working world begins with asking better questions. Better questions lead to better answers. To help preparers of financial statements and their auditors with Canadian accounting standards for private enterprises (ASPE) Section 3856, Financial Instruments, we’ve summarized the key aspects of the section and offer relevant practical considerations for private mid-market companies through seven commonly asked questions.

Question 1: What is a financial instrument?

Paragraph 3856.05(i) defines a financial instrument as a contract that creates a financial asset for one entity and a financial liability or equity instrument for another entity.

A financial asset is further defined in paragraph 3856.05(h) as any asset that is either:
- Cash;
- A contractual right to receive cash or another financial asset from another party;
- A contractual right to exchange financial instruments with another party under conditions that are potentially favourable; or
- An equity instrument of another entity.

A financial liability is defined in paragraph 3856.05(j) as any liability that is a contractual obligation to either:
- Deliver cash or another financial asset to another party; or
- Exchange financial instruments with another party under conditions that are potentially unfavourable to the entity.

Question 2: How is a financial instrument initially measured?

As described in paragraph 3856.07, when a financial asset is originated or acquired or a financial liability is issued or assumed in an arm’s-length transaction, an entity 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.

Paragraph 3856.08 further describes that when a financial asset is originated or acquired or a financial liability is issued or assumed in a related party transaction, an entity shall measure it in accordance with Section 3840, Related Party Transactions. As noted in paragraph 3856.09, parties whose sole relationship with the entity is in the capacity as management are deemed to be unrelated third parties for the purposes of Section 3856.
How is a financial instrument subsequently measured?

An entity may irrevocably elect on initial recognition of a financial instrument to subsequently measure it at fair value. If no election is made, financial instruments are subsequently measured as follows:

- Investments in equity instruments that are quoted in an active market and derivative contracts are subsequently measured at fair value, except for derivatives that are designated in a qualifying hedging relationship and derivatives that are linked to, and must be settled by delivery of, equity instruments of another entity whose fair value cannot be readily determined.
- Investments in all other equity instruments are subsequently measured at cost less any reduction for impairment.
- All other financial assets and financial liabilities are subsequently measured at amortized cost.

Unlike many other accounting frameworks, ASPE does not require accounting for embedded derivatives. However, as described in paragraph 3856.14, at each reporting date, the issuer of a financial liability that is indexed to a measure of an entity’s financial performance or to changes in the value of the entity’s equity adjusts the carrying amount of the liability to the higher of the amortized cost of the debt and the amount that would be due at the balance sheet date if the formula determining the additional amount was applied at that date.

When is a financial asset tested for impairment and how is impairment measured?

Paragraph 3856.16 describes that at the end of each reporting period, an entity shall assess whether there are any indications that a financial asset, or group of similar financial assets, measured at cost or amortized cost may be impaired. When there is an indication of impairment, an entity shall determine whether a significant adverse change has occurred during the period in the expected timing or amount of future cash flows from the financial asset or group of assets. As described in paragraph 3856.17, when such a change is identified, the carrying amount of the asset or group of assets is reduced accordingly. Examples of such impairment indicators as noted in paragraph 3856.A15 may consist of, but are not limited to, significant financial difficulty of the customer or issuer, a breach of contract or a significant adverse change in the technological, market, economic or legal environment.
When a reporting entity issues a financial instrument, how does it determine whether it is a financial liability or an equity instrument?

As described in paragraph 3856.A22, the substance of the contractual terms of a financial instrument, rather than its legal form, governs its classification on the issuer's balance sheet. While substance and legal form are commonly consistent, this is not always the case. For example, some financial instruments take the legal form of equity but are liabilities in substance, and others may combine features associated with equity instruments and features associated with financial liabilities.

The classification of an instrument is made on the basis of an assessment of its substance when it is first recognized based on the definitions of a financial liability and an equity instrument. Such a classification is not circumvented by non-substantive or minimal features included in the financial instrument. Any non-substantive or minimal feature is disregarded in applying the classification provisions of Section 3856. Judgment, based on consideration of all of the terms of an instrument and other relevant facts and circumstances, is necessary to distinguish substantive, non-minimal features from non-substantive or minimal features. The classification made at inception continues at each subsequent reporting date until the terms of the financial instrument change or it is removed from the entity's balance sheet.

An exception is provided in paragraph 3856.23 when an entity issues preferred shares in a tax planning arrangement under Sections 51, 85, 85.1, 86, 87 or 88 of the Income Tax Act (Canada). In such circumstances, the entity shall present the shares at par, stated or assigned value as a separate line item in the equity section of the balance sheet, with a suitable description indicating that they are redeemable at the option of the holder. When redemption is demanded, the issuer shall reclassify the shares as liabilities and measure them at the redemption amount. Any adjustment shall be recognized in retained earnings.
**How is a financial instrument that contains both a liability and an equity component accounted for?**

Such a financial instrument is either recognized entirely as a liability or allocated between a liability and equity component, depending on the circumstances. Paragraph 3856.21 indicates that the issuer of a financial instrument that contains both a liability and an equity element, including warrants or options issued with and detachable from a financial liability, shall classify the instrument’s component parts separately.

Paragraph 3856.22 indicates that the acceptable methods for initial measurement of the separate liability and equity elements of such an instrument include:

- Measuring the equity component as zero, with the entire proceeds of the issue allocated to the liability component; or
- The less easily measurable component is allocated the residual amount after deducting from the entire proceeds of the issue the amount separately determined for the component that is more easily measurable.

**What is hedge accounting and how does it impact a reporting entity’s financial statements?**

Hedge accounting applies to derivative financial instruments. Hedge accounting is a method of recognizing the gains, losses, revenues and expenses associated with 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.

Examples of derivative instruments and hedging relationships include forward contracts to mitigate fluctuations in foreign currency cash flows and interest rate swap agreements to mitigate the effects of changes in interest rates. Moreover, a thorough understanding of derivatives should be obtained prior to entering into such agreements, as hedging does not guarantee positive outcomes.

ASPE contains narrow-scope guidance on conditions that must be satisfied in order for a given hedging relationship to qualify for hedge accounting, as well restrictions on the types of hedging relationships to which hedge accounting can be applied. Hedge accounting is optional and cannot be discontinued electively. Refer to paragraphs 3856.30–3856.36 and 3856.A62–3856.A65 for the aforementioned guidance, as well as for guidance on how to account for a qualifying hedging relationship.

To learn more about these items or for application guidance, please contact our Private Mid-Market practice at privatecompanyinfo@ca.ey.com.
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