DEFINITIONS

- **Financial Instrument** is a contract that creates a financial asset for one entity and a financial liability or equity instrument of another entity.

- **Financial Asset**
  - cash
  - an **equity instrument** of another entity;
  - a contractual **right** to **receive cash** or another financial asset from another entity; or
  - a contractual **right** to **exchange financial assets** or **financial liabilities** with another entity under conditions that are potentially favourable to the entity

- **Financial Liability**
  - a contractual obligation to **deliver cash or another financial asset** to another entity; or
  - a contractual obligation to **exchange financial assets** or **financial liabilities** with another entity under conditions that are potentially **unfavourable** to the entity; or

MEASUREMENT OF FINANCIAL INSTRUMENTS:

- **Initial measurement - at the amount you paid for it (i.e. cost)**

- **Subsequent measurement**

  I. Investments in Equity Instruments
     - If quoted in an active market (i.e. publically trades shares) - measure @ FV
     - If not quoted in an active market - measure @ cost

  II. Other Financial Assets
     - Amortized cost

  III. Financial Liabilities
     - Amortized cost

  IV. Under ASPE you have the option to designate any **financial instrument** to be measured @ fair value
     - *3856:13 says- An entity may elect to measure any financial asset or financial liability at fair value by designating that fair value measurement shall apply*

  V. If active market disappears you have 2 options: designate FV or use cost onwards

Transaction costs

- Transaction costs = costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (i.e. legal fees, commission, transfer taxes)
- Only capitalize transaction costs and fees on investment purchases if they're **not** going to be revalued to FV @ the end of the period (i.e. active market does not exist **or** not designated to be held at FV)

- In other words, If you're buying an investment that's carried at cost then capitalize transactions costs

Impairment of financial assets

- For financial assets that are recorded at **cost** you need to assess at the end of every fiscal year if there are indications of impairment
- If there are indications of impairment write down the financial asset to the **highest** of:
  - **Higher** of
    1. PV future expected CF (using **current** **MKT** rate) by holding the asset
    2. Selling Price
    3. Amount realizable from collateral ***net of costs***
       - This makes sense because the lender would want to choose the higher option

- What if the value of these financial assets subsequently increases? You are allowed to write up to the extent of previous losses taken

PRESENTATION OF A FINANCIAL INSTRUMENT

- The issuer either records financial instruments as liabilities or equity
- The key takeaway here is substance over form - just because someone issues preferred shares; in legal form it may be shares; but in substance it may be a liability (so please consider the definition of financial assets/liabilities before making the classification)

Compound Financial Instrument

- Compound financial instrument has both equity and liability components
- *Example: ABC Bank issues to me a convertible debt; the bank has the option to convert this debt into a fixed number of shares (say 100 shares).*
  - This particular instrument has both a debt component - i.e. the loan
  - It also has an equity component because the bank has the option to convert to a fixed number of shares
  - One other thing to take away is that because this is a convertible debt, its less risky for the lender and therefore it has a lower interest rate

- **2 Options to measure compound financial instruments under ASPE**
  1. Allowed to make equity = 0 and liability = entire amount of proceeds **OR**
  2. Measure the more **easy to measure** of the liability or equity (this is usually the PV of the liability using interest rate without the conversion option) and allocate the remainder of the proceeds to the other component (usually equity)

Mandatory Redemption/ Retractable Shares

- This is when either you must redeem your shares or the holder of the shares has the right to force you to redeem
  - Substance over form kicks in; it is a financial liability because it is a contractual obligation to **deliver cash**
  - Once these “shares” are presented as financial liability any dividends you pay are actually interest and shown as interest expense (rather than a dividend through R/E)

- If shares have mandatory redemption/retractable feature and they are like common shares (i.e. the most subordinate) then it is treated as equity. These shares must have **all** the following properties to be classified as equity:
  - Most subordinate of all shares (like common shares)
  - Available to 100% of common shareholders
  - The shares get a pro rata share of the residual equity
  - No preferred rights to other share classes
  - Redemption event same for all classes

- The reasoning behind this is that there needs to be at least one common share (i.e. most subordinate class of shares) issued for a company

Preferred shares issued under tax planning arrangements (i.e. 51, 85, 85.1, 86, 87 or 88)

- **MUST** classify this as **equity** (in a separate line item)
- When shares are redeemed **reclassify** it to liability with any gain or loss put through **Retained Earnings**

P/Shares issued in tax planning arrangement	100	
Retained Earnings	50	
Liability to investor		150

Contingent settlement provisions

- Example: I issue shares for $5/share; if the share price in the future drops below $2/share, I am forced to redeem all the shares.
- Under ASPE, the default is to classify this as equity – but if the event is highly likely to occur it should be classified as a liability.

Perpetual Debt

- These are debt instruments where the principal is never due; you just continue to pay interest
- Is this a financial liability or equity?
  - This is a financial liability because a contractual obligation to **deliver cash (interest)**
  - The PV of the future interest cash flows is shown on the balance sheet as a financial liability accounted for using amortized cost method!

Offsetting Financial Asset and Financial Liability

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

1. Currently has a **legally enforceable right** to set off the recognized amounts; and
   - Therefore, there needs to be contract in place that allows a borrower to offset the amount owing to and owing from a creditor
   - In rare cases, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor, provided that there is an agreement among the three parties that clearly establishes the debtor's right of set-off.

2. **Intends** either to settle on a net basis, or to realize the asset and settle the liability simultaneously.