FREELANDT CALDWELL REILLY LLP
CHARTERED PROFESSIONAL ACCOUNTANTS

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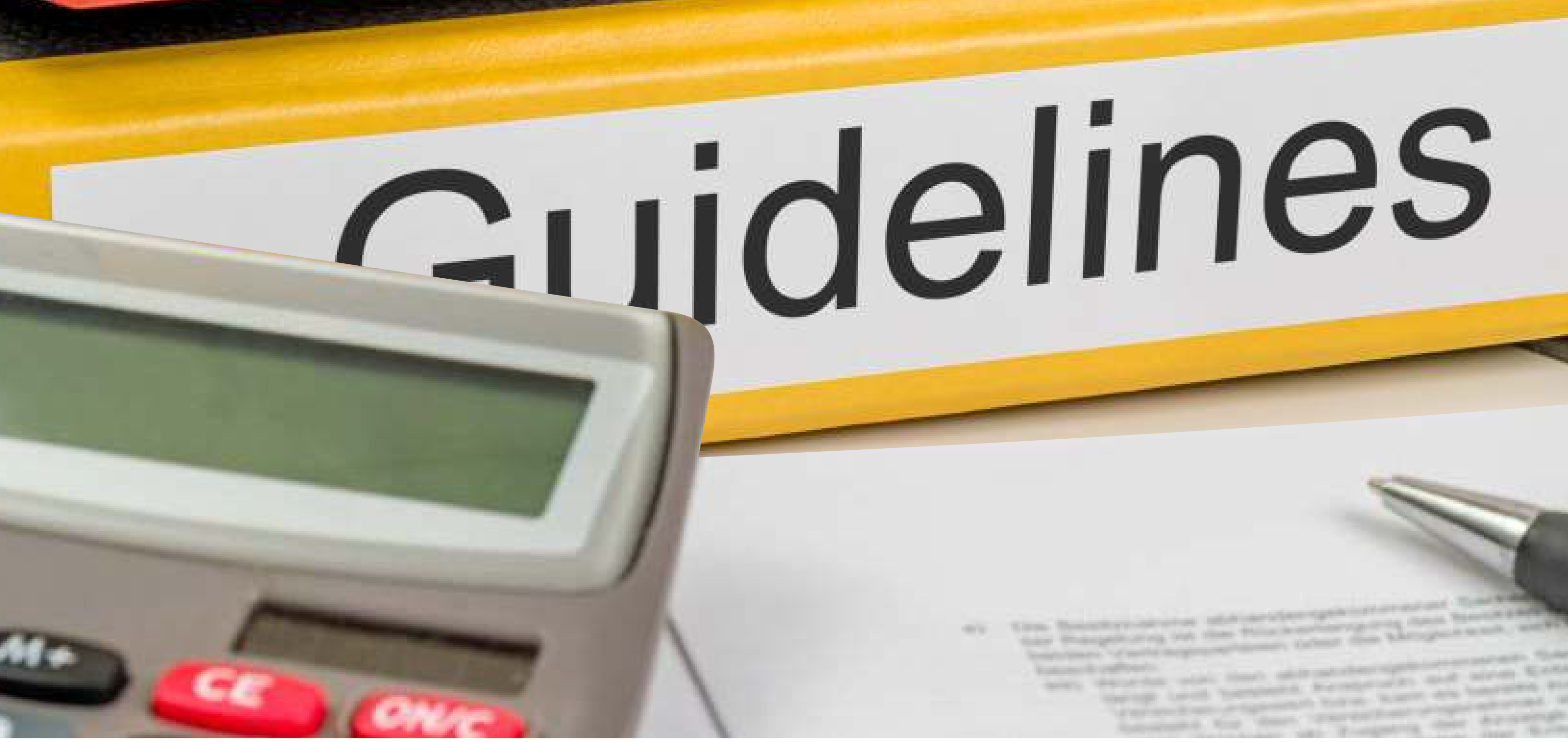
RECENT CHANGES TO RETRACTABLE OR MANDATORILY REDEEMABLE SHARES

Changes effective for fiscal years beginning on or after January 1, 2021



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SUMMARY OF CHANGES

Recent amendments to Section 3856 Financial Instruments could result in significant changes to the presentation of retractable or mandatorily redeemable shares (ROMRS)

ROMRS will now be required to be presented as debt at their redemption value unless the transaction giving rise to the ROMRS meets certain criteria and the entity in question chooses to continue to present these shares as equity.

These include:

1. Holder of the ROMRS retains control of the enterprise;
2. No consideration other than shares are included as part of the transaction; and
3. No redemption arrangements are in place.

The resulting changes in presentation could be significant and can impact the calculation of debt covenants and influence other agreements. We encourage you to discuss these changes with your FCR advisor today.

The information in this publication is current as of January 1, 2021.

Recent changes found in Accounting Standards for Private Enterprises Section 3856 Financial Instruments of Part II of the CPA Canada Handbook - Accounting could have a big impact on your company's financial statements if those statements include preferred or special shares.

Preferred shares are used in commercial enterprises for a variety of reasons and can hold a number of different attributes. They are commonly used in tax planning arrangements, estate planning, and ownership transition. Preferred shares can be used to "freeze" the value of an enterprise at a given point in time. These "freeze" shares often include a feature making them retractable at the option of the holder or mandatorily redeemable by the enterprise at some point in the future at a price equal to the fair market value of the common shares being exchanged on their issuance.

Essentially, the issue at hand is that these preferred shares resemble callable or scheduled debt in many respects. In fact, these shares meet the definition of a liability in Canadian Accounting Standards for Private Enterprises. Prior to the standard changes, it was only through an exception that these shares were classified as equity. Effective for fiscal years beginning on or after January 1, 2021 these retractable or mandatorily redeemable shares (commonly referred to as "ROMRS") may require reclassification as a liability and recognition at their full redemption value on the enterprise's balance sheet.

ASSESSING THE IMPACT

The reclassification and remeasurement of the ROMRS may have a significant impact on the presentation of the financial position of an affected enterprise. What was previously presented within equity at a nominal amount, could now be presented as a substantial current liability. An offsetting adjustment will also see a decrease in retained earnings of the enterprise and any dividends on the ROMRS will be classified as interest expense.

While nothing has actually changed with the enterprise, the change in presentation could lead to many questions and concerns from unsuspecting users of the financial statements. Consider how banking agreements, debt covenants, and other agreements may be affected by the change in presentation. It is important to understand the impact of this change and how it will affect your enterprise. Before implementation you will have time to communicate with the stakeholders affected and determine suitable actions and necessary adjustments.

Each class of preferred share as well as each shareholder of each class must be analyzed separately to determine if their ROMRS will be impacted. If certain conditions are met, the ROMRS can remain in equity at their par, stated, or assigned value. Otherwise, they will be reclassified as a liability at their redemption value.

COMMON CHARACTERISTICS OF ROMRS

- holder has the right to require redemption on demand at a price equal to the fair market value of the common shares exchanged
- shares have, at least, voting rights on any matter involving a modification to their attributes
- shares have no restrictions on their transfer
- shares have priority on distribution and liquidation over at least one class of shares
- shares were issued as part of a tax planning arrangement

CONDITIONS FOR EQUITY CLASSIFICATION

ROMRS issued in a tax planning arrangement can be classified as equity if all three of the following conditions are met:

1 | The shareholder receiving the ROMRS retains control of the enterprise.

Control is an important factor because it helps you determine if someone other than a controlling party can effectively force a payment/redemption of the ROMRS to occur. Shares of a non-controlling interest that are ROMRS must be classified as a liability. The treatment of the shares within a class that has multiple shareholders could differ based on control.

The ability to control an organization is defined as the continuing power to determine an organization's strategic operating, investing and financing policies without the cooperation of others. That can be a lot to unpack and often professional judgement is required to determine when control exists based on the facts of each situation. Control can be established through shares and votes, or through other means like contractual or legal agreements.

A key factor in this analysis is the fact that only one party can have control. Take for instance a situation in which an enterprise is owned 50/50 by spouses. If control is determined by other means than solely voting and one spouse holds control, the other's shares will be classified as a liability. If joint control is established and no party can take action without the other's consent, then all of the ROMRS would be classified as a liability. It should also be noted that not exercising a shareholder's rights does not preclude that they exist. This can often be the case when you have an active and a silent shareholder. Not influencing day-to-day operations does not mean the ability and right is not actually there.

2 | No consideration other than shares are included as part of the transaction.

The ability to continue to present ROMRS as equity is targeted at a specific type of transaction, specifically tax planning arrangements that do not result in substantive changes to an enterprise. When shares are exchanged for different types of shares and no change in ultimate ownership occurs, the economics of the organization do not substantially change and therefore equity classification of the ROMRS is still appropriate.

When consideration other than shares (cash, promissory notes, equipment rollovers, etc.) form part of the tax planning arrangement, there will be an impact on the enterprise's future cash flows and the ROMRS associated with the transaction do not qualify for equity treatment. In many situations, nominal amounts of cash are involved in the subscription of shares, but this must be considered in terms of the transaction as a whole and whether these small amounts are inconsequential to the outcome of the tax planning arrangement.

Consideration should also be given to transactions that happen as a series of transactions for tax and legal purposes. The transactions must be considered holistically to determine if consideration other than shares form part of the arrangement.

3 | No redemption arrangement is in place.

The final condition that must be met is the fact that there can be no scheduled redemption plan or arrangement in place for the ROMRS. If a schedule is in place, then known cash outflows will occur and the ROMRS take on the characteristics of debt and are classified as such. A redemption arrangement can come in many forms and appear in many places. Written and oral arrangements must be considered as well as past practices which may indicate an informal plan is in place. These types of arrangements can appear in shareholder agreements, purchase and sale agreements, minutes to meetings, banking agreements, or may be informally accepted through verbal agreements.

EFFECTIVE DATE AND TRANSITION

These amendments will be applicable for fiscal years beginning on or after January 1, 2021. Indeed, many people will be seeing the actual impact of these changes next year when sitting down to review their financial statements. Early adoption is permitted, which may make sense for transactions that are currently being completed. Otherwise, statements ending on or after December 31, 2021 will be the statements that are substantially impacted.

In terms of presentation, an organization may choose to apply and present the change in only the year the change takes effect. For instance, an organization with a December 31, 2021 year end may present the change at January 1, 2021. This means the comparative figures will reflect what had previously been presented, with no changes noted. Visually, this will result in a significant change year over year as a liability that was not visually present is now recognized.

Alternatively, the organization may choose to present the impact of the change at the beginning of the earliest period presented. In this case, the reclassification to a liability would be presented on January 1, 2020 and the comparative figures would be restated to reflect the liability presentation. The selection of the presentation method could impact the users of the financial statements and it is important to ensure they understand the method selected and it's implications.

AMENDMENT DATES & TRANSITIONS

December 31, 2019 | December 31, 2020 | December 31, 2021

Apply at the beginning of period amendments first apply (December 31, 2020 – December 31, 2021)

Apply at the beginning of earliest period presented (December 31, 2019 – December 31, 2021)

Financial statement meetings (after December 31, 2020)

no change in presentation, unless early adoption

identify and discuss with impacted stakeholders

Financial statement meetings (after December 31, 2021)

new presentation

discuss with stakeholders

IMPACT OF THE CHANGE

If an organization has ROMRS that do not meet the conditions to be presented as equity, the impact and change in presentation can be significant. First, a liability is recognized at the redemption value of the shares. This liability will often be presented as a current liability, but certain exceptions may apply.

The recognition of the liability also requires an offsetting adjustment to retained earnings which can be shown as a direct reduction of retained earnings or shown as another identifiable item within the equity section. Any dividends declared on the ROMRS will be presented as an interest expense in the statement of operations.

See Appendix A and B for sample financial statements with and without the reclassification.

The biggest concern with this change in presentation is the potential impact it could have on agreements that use the financial statements as a reference point. Changes to liabilities, equity, and interest expense will impact financial ratios. Debt covenants and contractual arrangements may be affected. While fundamentally, nothing will have changed with the organization, stakeholders may be shocked when they compare the financial statements to past periods.

We encourage you to consider the impact of this significant change and how it could affect your enterprise. Consider your stakeholders and whether they will be influenced by the change in presentation. Early education and proactive discussions will go a long way to minimize issues with these stakeholders.

We encourage you to reach out to your FCR advisor to discuss how these changes relate to your enterprise and the potential impact it may have.

APPENDIX A - WITHOUT RECLASSIFICATION

ABC Company
Statement of Financial Position
December 31, 2021 with comparative figures for 2020

(unaudited)	2021	2020
Assets		
Current		
Cash	$ 500,000	$ 150,000
Accounts receivable	250,000	200,000
Prepaid expenses	25,000	20,000
	775,000	370,000
Property, plant and equipment	2,000,000	1,550,000
Assets under capital lease	200,000	215,000
Goodwill	2,000,000	2,000,000
	$ 4,975,000	$ 4,135,000
Liabilities and shareholders' equity		
Current		
Accounts payable and accrued liabilities	$ 150,000	$ 175,000
Income taxes payable	50,000	25,000
Current portion of long term debt	75,000	100,000
Current portion of capital lease obligation	50,000	25,000
Current portion of mortgage due on demand	100,000	110,000
	425,000	435,000
Mortgage due on demand	1,350,000	1,400,000
	1,775,000	1,835,000
Long term debt	750,000	85,000
Capital lease obligation	75,000	100,000
	2,600,000	2,020,000
Shareholders' equity		
Common shares	100	100
Preferred shares *($1,000,000 aggregate redemption value, redeemable at the option of the holder)*	10	10
Retained earnings	2,374,890	2,114,890
	2,375,000	2,115,000
	$ 4,975,000	$ 4,135,000

ABC Company
Statement of Operations
Year ended December 31, 2021 with comparative figures for 2020

(unaudited)	2021	2020
Revenue	$ 5,280,000	$ 4,750,000
Cost of sales	3,500,000	3,200,000
	1,780,000	1,550,000
Expenses		
Wages and benefits	800,000	755,000
Occupancy costs	200,000	175,000
Amortization	200,000	185,000
Interest on callable debt and long-term debt	100,000	125,000
Office and general	50,000	45,000
Repairs and maintenance	30,000	35,000
Insurance	15,000	15,000
Advertising and promotion	6,667	10,000
Vehicle	5,000	5,000
	1,406,667	1,350,000
Earnings before income taxes	373,333	200,000
Income taxes	93,333	50,000
Net earnings	280,000	150,000
Retained earnings, beginning of the year	2,114,890	1,984,890
Dividends on preferred shares	(20,000)	(20,000)
Retained earnings, end of year	$ 2,374,890	$ 2,114,890

APPENDIX B - WITH RECLASSIFICATION

ABC Company
Statement of Financial Position
December 31, 2021 with comparative figures for 2020

(unaudited)		2021	2020
Assets			
Current			
Cash		$ 500,000	$ 150,000
Accounts receivable		250,000	200,000
Prepaid expenses		25,000	20,000
		775,000	370,000
Property, plant and equipment		2,000,000	1,550,000
Assets under capital lease		200,000	215,000
Goodwill		2,000,000	2,000,000
		$ 4,975,000	$ 4,135,000
Liabilities and shareholders' equity			
Current			
Accounts payable and accrued liabilities	**Note current liability classification**	$ 150,000	$ 175,000
Preferred shares*		1,000,000	1,000,000
Income taxes payable		50,000	25,000
Current portion of long term debt		75,000	100,000
Current portion of capital lease obligation		50,000	25,000
Current portion of mortgage due on demand		100,000	110,000
		1,425,000	1,435,000
Mortgage due on demand		1,350,000	1,400,000
		2,775,000	2,835,000
Long term debt		750,000	85,000
Capital lease obligation		75,000	100,000
		3,600,000	3,020,000
Shareholders' equity			
Common shares		100	100
Retained earnings	**Offsetting adjustment to equity**	2,374,890	2,114,890
Other equity		(999,990)	(999,990)
		1,375,000	1,115,000
		$ 4,975,000	$ 4,135,000

***Assumes no redemption arrangement in place and shareholder has not waived the right to demand**

ABC Company
Statement of Operations
Year ended December 31, 2021 with comparative figures for 2020

(unaudited)	2021	2020
Revenue	$ 5,280,000	$ 4,750,000
Cost of sales	3,500,000	3,200,000
	1,780,000	1,550,000
Expenses		
Wages and benefits	800,000	755,000
Occupancy costs	200,000	175,000
Amortization	200,000	185,000
Interest on callable debt and long-term debt and dividends on prefered shares	120,000	145,000
Office and general	50,000	45,000
Repairs and maintenance	30,000	35,000
Insurance	15,000	15,000
Advertising and promotion	6,667	10,000
Vehicle	5,000	5,000
	1,426,667	1,370,000
Earnings before income taxes	353,333	180,000
Income taxes	93,333	50,000
Net earnings	260,000	130,000
Retained earnings, beginning of the year	2,114,890	1,984,890
Dividends on preferred shares	—	—
Retained earnings, end of year	$ 2,374,890	$ 2,114,890

Dividends are presented as interest expenses for accounting purposes

IMPACT ON COVENANTS

The implementation of the new standard could have far reaching impacts on the calculation of certain covenants that may be in place as a result of the reclassifications. For this reason, banking agreements and other arrangements may need to be revisited to ensure there are no interruptions or issues arising from the change in presentation.

		Before		After	
Curent ratio:	Current assets / Current liabilities	775,000 / 425,000	1.82	775,000 / 1,425,000	0.54
Quick ratio:	Quick assets / Current liabilities	750,000 / 425,000	1.76	750,000 / 1,425,000	0.53
Debt to equity ratio:	Debt / Owner's equity	2,600,000 / 2,375,000	1.09	3,600,000 / 1,375,000	2.62
Debt ratio:	Debt / Total assets	2,600,000 / 4,975,000	0.52	3,600,000 / 4,975,000	0.72
Debt service coverage	EBIT A / Interest & principal on LTD	673,333 / 200,000	3.37	673,333 / 200,000	3.37

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301- 62 Frood Rd.
Sudbury ON P3C 4Z3
Ph: (705) 675-2200
Fax: (705) 675-2515

30 McCulloch Dr.
Espanola ON P5E 1J1
Ph: (705) 869-3351
Fax: (705) 869-4601

www.fcrca.com | fcr@fcrca.com