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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **13 December 2006, London**

Project: **Financial Instruments – Due Process Document (DPD)**

Subject: **Recognition and Measurement – (Agenda Paper 12B)**

CONTENTS OF PAPER

1. This paper discusses whether bank deposit agreements should be recognized and, if so, how they should be measured.

2. This paper does *not* address outstanding deposit balances – the liability the depository entity has for the funds already on deposit. Such balances are the amounts owed by a depository entity to a depositor as a result of accepting deposits and are financial instruments. Paper 12C discusses the measurement of liabilities with a demand feature, which includes many deposit balances.

BACKGROUND

3. Deposit agreements are the agreements that set the terms under which the depository entity (a 'bank') and the holder of the demand deposit account will conduct business. Such agreements are typically open-ended and do not carry an expiration date.

4. Such agreements give the depositor an ability to seek a promissory note payable on demand from the bank in exchange for cash (a call option on a bank liability). Such promissory notes often carry an interest rate close to zero (or sometimes do not even pay interest).

ARE DEPOSIT AGREEMENTS FINANCIAL INSTRUMENTS?

5. An exchange contract within the DPD's draft definition of a *financial instrument* requires that there be "a contractual obligation of one party to exchange financial instruments with a second party and a contractual right of the second party to require an exchange of financial instruments with the first party". That is, there needs to be both a contractual right and an obligation.

6. If under a deposit agreement a bank is contractually obliged to accept deposits in exchange for a promissory note then a contractual right (of the depositor to deposit money) and a contractual obligation to stand-by to accept deposits exists. In such a situation the deposit agreement would meet the definition of a (contractual) financial instrument.

7. However, if under a deposit agreement a bank does not have an obligation to accept deposits, then the deposit agreement is not a *financial instrument.*

8. Many deposit agreements explicitly allow the bank to refuse part or all of a deposit. Thus the customer does not have an explicit right to call a promissory note.

9. However, it is clearly standard business practice for a bank to accept deposits once a deposit agreement has been entered into. There, of course, are exceptions such as if the bank believes that the funds are from illegal sources.

10. Where it is standard business practice to accept deposits an *implied* obligation may exist. (Implied contracts may be created by normal business practices under US law and in certain other jurisdictions as well.) By the way in which a bank normally carries out its business (such as accepting deposits) the bank may have created an impression that it will continue to accept deposits – and if it refuses to

accept a deposit after implying by its previous practice that it will accept deposits that are not illegal, and its refusal harms the depositor, the bank may be liable for damages.

11. However, it is difficult to reach a definitive answer as to whether such an implied obligation actually exists. A test of whether such an implied obligation exists is if that possible obligation has ever been tested at law. Several years ago - as part of the research that preceded the publication of the FASB Preliminary Views on *Reporting Financial Instruments and Certain Related Assets & Liabilities at Fair Value* - the FASB staff was unable to identify any court cases in which the legal enforceability of the obligation of a US bank to accept deposits had been tested.

12. If a present obligation does not exist a deposit agreement is not a financial instrument.

13. If a present obligation does exist (and the depositor has a present right to call a bank liability by making a deposit), the resultant questions are

    a. Whether deposit agreements should be recognized

    b. And, if recognized, how the fair value of deposit agreements should be measured.

Staff recommendation

14. Deposit agreements cannot be demonstrated to be financial instruments. The key question is therefore whether a deposit agreement is sufficiently similar to a financial instrument to be included in the scope of the DPD and be measured at fair value. One of the considerations in answering this question would be whether the incremental information would provide decision useful information to the users of the financial statements.

15. The staff recommends that deposit agreements are not included in the scope of the DPD given the uncertainty regarding whether such agreements are financial instruments. However, the staff does recommend that the DPD includes a

discussion of deposit agreements, and seeks the views of respondents as to whether such agreement should be recognized and accounted for as if they were financial instruments.

16. **Questions to the Boards:**

    a. **Do you want to state a preliminary view regarding whether deposit agreements should be included in the scope of the DPD? If so, what is that view?**

    b. **If you believe you could answer that question if some additional information were provided, what additional information would you need?**