



30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

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: 19th September 2006, London

Project: Financial Instruments – Due Process Document (DPD)

Subject: Scope – Setting the initial scope on the basis of the characteristics of contractual rights and obligations (Agenda Paper 4A)

BACKGROUND

1. At the June Board meeting, the IASB expressed interest in considering an alternative approach to using a definition of *financial instruments* as a way to set the scope of the DPD. At their June education session, the FASB expressed no support for basing the scope of the DPD on anything other than a definition of *financial instruments*.
2. Consequently, this paper is a compromise. It does not consider whether or not to base the scope of the DPD on **all** contractual rights to receive and obligations to deliver an item, regardless of what that item might be.
3. Although such a scope seems to be a more natural starting point than a definition of *financial instruments*, such a scope is considered too broad to be acceptable to either of the Boards or their constituents.

4. However, because the IASB expressed interest in considering a scope broader than *financial instruments* (in order to avoid creating a subsequent list of other items to either (a) include related or similar contracts, or (b) exclude certain types of financial instruments), this paper is directed at that objective.
5. Paper 4B discusses basing the initial scope on a definition.

CONTENTS OF THIS PAPER

6. This paper primarily considers two different issues:
 - a. It analyzes the characteristics of contracts currently accounted for similarly to financial instruments (in IFRS) or as derivatives (in U.S. GAAP) to understand whether we can identify a principle to use in setting the scope of the DPD.
 - b. It addresses whether non-contractual obligations (statutory or other legal) to pay cash might also be included in the scope of the DPD.
7. However, before consideration of these two issues, the paper briefly considers what we mean by references to *contract* and *contractual*.

MEANING OF *CONTRACT* AND *CONTRACTUAL*

8. References to *contract* and *contractual* in this series of papers and for the purposes of the DPD mean those contracts (whether oral, written or implied) that are enforceable at law.
9. The possible interaction between the law and the rights and obligations that form a contract will need to be addressed in the DPD. For example, in particular jurisdictions the operation of the law may result in a different form or amount of settlement than that specified in the contract.

CHARACTERISTICS OF CONTRACTS SIMILAR TO FINANCIAL INSTRUMENTS

Characteristics of Financial Instruments

10. To identify the similarities between financial instruments and other contracts, it is necessary to first consider the characteristics of financial instruments.
11. There are three types of financial instruments – cash, ownership interests, and certain contracts.
12. As we are seeking to identify similarities with other types of contracts that we account for similarly to financial instruments, this paper focuses on the characteristics of **contractual** financial instruments.
13. Contractual financial instruments come in two forms – delivery contracts and exchange contracts:
 - a. Delivery contracts require one party to deliver cash, an ownership interest, or a contractual financial instrument to the other party for no consideration (other than a release from the obligation). For example, accounts payable and receivable, loans, and bonds are common examples. Such delivery contracts usually arise from past transactions – the obligated party has already received something (such as cash, goods, or a service)¹.
 - b. Exchange contracts require both parties to deliver cash, an ownership interest, or a contractual financial instrument and give each party the right to receive cash, an ownership interest, or contractual financial instruments from the other.
14. These descriptions include *contractual financial instrument* within the description of a contractual financial instrument. This is not a circular reference. A contractual financial instrument is a link in a chain of instruments that ultimately requires delivery of cash or ownership interests. For example, a forward contract

¹ Certain nonreciprocal transactions (such as pledges to charity or the declaration of dividends to owners) may also create enforceable obligations in some jurisdictions. For such transactions, however, only one party is required to deliver.

to purchase government bonds requires delivery of cash against exchange of the bond. The bond itself also eventually contractually results in cash being delivered (though interest and principal repayment) by the government to the holder of the bond.

15. The key characteristic of a contractual financial instrument is the contractual link to cash or an ownership interest. There is no requirement to be able to sell such contracts to realize cash or an ownership interest; eventually the performance required by the contract (or chain of contracts) results in the realization of cash or ownership interests.

Characteristics of contracts accounted for similarly to Financial Instruments or Derivative Instruments

16. Contracts that are not financial instruments but that are accounted for similarly to financial instruments (under IAS 39 *Financial Instruments: Recognition and Measurement*) or as derivative instruments (under Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*) are those for which an outcome similar to a financial instrument is probable.
17. Such an outcome is probable when an entity has **both** the ability and intent to net settle a non-financial contract in cash or another financial instrument or to sell the contract in the short term.
18. Taking intent first, an entity demonstrates its intent by not electing, or qualifying for, the 'normal' purchase or sale exceptions of IAS 39 and Statement 133.
19. Turning to ability, IAS 39 and Statement 133 set out various ways in which ability to net settle or sell in the short term are demonstrated. These ways (which are a paraphrased mixture of IAS 39 and Statement 133) are when:
- a. There is a contractual option to net settle in cash or another financial instrument
 - b. An entity has a practice (without an explicit contractual provision) of net settlement

- c. An entity has a practice of taking delivery and selling within a short period for 'trading' purposes
 - d. The item to be delivered is readily convertible to known amounts of cash (that is, there is a liquid market).
20. The contractual net settlement option is very similar to the contractual outcome of a financial instrument. A past practice of taking delivery and selling in a short period is not as similar to the contractual outcome of a financial instrument.
21. However, any of the ways set out in paragraph 19, when combined with management intent, result in a probable similar outcome to the contractual outcome of a financial instrument.
22. Some believe that items that have similar outcomes to financial instruments should be accounted for on the same basis as financial instruments, as there is no significant economic difference between such items and financial instruments. Another reason to account for items that have similar outcomes to financial instruments is to prevent accounting abuse (such as, for example, including non-substantive delivery provisions to achieve a desired accounting effect). Furthermore, items that have similar outcomes to financial instruments can be measured using similar (if not the same) valuation approaches to those used to measure financial instruments.
23. Others believe that only items that meet the definition of a financial instrument should be accounted for as a financial instrument, and that the other items should be considered separately.
24. However, based on the view that items that have similar outcomes to financial instruments should be accounted for on the same basis as financial instruments, it is possible to derive a principle-based scope for the DPD–financial instruments and contracts with the same probable outcomes.
25. Of course, a question to be addressed is: how probable must it be that the outcome of a contract will be the same as a financial instrument? The outcomes in all of

the examples previously discussed are highly probable (although it is not possible to assign a percentage).

Financial Instrument Servicing Contracts

26. Financial instrument servicing contracts² are another type of contract that U.S. GAAP treats similarly to financial instruments. Such contracts typically arise when:
- a. Financial instruments (such as loans) are sold from one entity (often the originating entity) to another entity, and the seller retains the servicing, or
 - b. A holder of a financial instrument signs a servicing contract with another entity.
27. Under such arrangements, the servicer collects payments and remits the payments (less a percentage equal to the servicing fee) to the owner(s) of the serviced assets. The contract could be an asset or a liability to the servicer depending on whether the fair value of the servicing costs exceeds the fair value of the fees charged. The holder of the financial instrument excludes the cash flows that will be retained by the servicer from the value of the financial instrument and does not recognize the servicing contract separately.
28. Statement No. 156, *Accounting for Servicing of Financial Assets*, requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value. The statement permits a choice of remeasuring those contracts at fair value in each subsequent period or amortising the initial fair value (which is similar to some of the choices for financial instruments in Statement No. 115, *Accounting for Certain Interests in Debt and Equity Securities*).
29. The Basis for Conclusions of Statement 156 states that because loan-servicing contracts have characteristics similar to financial instruments, fair value is the most relevant measure for them. It does not cite any specific similarities, but the hedge accounting requirements of Statement 133 implies some similarities.

² Before such transactions, servicing is an inherent part of the cash flows of many financial instruments. However, **servicing rights** do not exist before a separate contract is entered into with another party.

30. Statement 133 generally prohibits hedging individual specific risks in a hedged item unless that hedged item is a financial instrument. Loan servicing contracts are an exception. The same risks may be hedged in a servicing right as in a financial instrument. Those risks include interest rate risk (and prepayment risk, which is considered a component of interest rate risk), credit risk, and foreign currency exchange risk. Hence, that identifies at least some of the risks that servicing contracts and financial instruments have in common.
31. So, it might be possible to identify another addition to the scope of the DPD – financial instruments and other contracts subject to the risks identified in the previous paragraph.
32. However, such a scope would be very similar to a scope of all contracts to deliver or exchange something of value.
33. An alternative approach might be to consider the payment streams of a financial instrument and servicing contract. The cash flows from a servicing contract come directly from the financial instrument and are collected in the same manner and as part of the same effort. However, if such a principle were used then probably no contracts other than servicing rights contracts would be included. It may be easier to specify servicing contracts rather than creating a principle that applies only to servicing contracts.
34. **Questions to the Boards:**
- a. **Should the scope of the due process document be based on the definition of a financial instrument or should it include items with similar probable outcomes?**
 - b. **If neither of those is the appropriate scope, what scope would you propose?**
 - c. **If you are not prepared to answer those questions, what additional information do you need?**

NONCONTRACTUAL OBLIGATIONS TO DELIVER CASH (OR OTHER FINANCIAL INSTRUMENTS) AND RIGHTS TO RECEIVE CASH (OR OTHER FINANCIAL INSTRUMENTS)

35. Financial instruments do not include legal but noncontractual obligations and rights to deliver or exchange financial instruments. Examples of such rights and obligations are taxes payable and refunds receivable, government fines or assessments, and environmental cleanup obligations imposed by regulatory bodies or courts.

36. Such rights and obligations are as enforceable as contracts (if not more so). Some do not raise issues that are any different to those raised by financial instruments. However, others (such as deferred taxes and uncertain tax positions) raise a whole range of different issues of uncertainties. For some (such as environmental cleanup obligations), the counterparty is not known. Most of these rights and obligations are dealt with by one or both Boards on an individual basis.

37. Questions to the Boards:

- a. **Should legal but noncontractual obligations to deliver cash (or other financial instruments) and legal but noncontractual rights to receive cash (or other financial instruments) be included in the definition of a *financial instrument*?**
- b. **If not, should they be included in the scope of the DPD?**
- c. **If you are not prepared to answer those questions, what additional information do you need?**