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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**19 September 2006, London**
Project:	**Financial Instruments – Due Process Document (DPD)**
Subject:	**Scope – A proposed definition of a 'financial instrument' (Agenda Paper 4B)**

PURPOSE OF THIS PAPER

1. Paper 4A discussed setting the scope of the DPD (in relation to contracts) by identifying those contracts with certain characteristics.

2. This paper takes the more traditional approach of using a definition of *financial instruments* as the initial basis and discusses possible reasons to change existing definitions of *financial instruments*.

A DEFINITION OF *FINANCIAL INSTRUMENTS*

Background

3. In paper 4A we identified the three basic types of financial instruments – cash, ownership interests, and certain contracts. We also identified the two forms of contractual financial instruments – delivery contracts and exchange contracts.

4. The two Boards could choose to use their separate existing definitions[1] due to constituent familiarity with them (although FASB constituents may have had little reason to apply the FASB definition because only the disclosure requirements in Statement No. 107, *Disclosures about Fair Value of Financial Instruments* and the derecognition requirements in Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* currently rely on the definition).

5. However, convergence is desirable. In addition, the existing definitions could use improvement for the reasons set out in this paper.

Proposed definition

6. To allow Board members to put the possible reasons for changing the definition into context, a draft definition of *financial instruments* proposed for the DPD is set out below:

   A *financial instrument* is defined as:

   (a) cash;

   (b) evidence representing a residual or other ownership interest in an entity;

   (c) a contractual obligation of one party to deliver a financial instrument to a second party and a corresponding contractual right of the second party to require receipt of that financial instrument in exchange for no consideration other than release from the obligation; or

   (d) 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.

   A *financial asset* is a financial instrument that is an asset.

   A *financial liability* is a financial instrument that is a liability.

   A *financial instrument* classified by an entity in the equity section of its balance sheet (or statement of financial position) is neither a financial asset nor a financial liability to that entity.

7. This draft definition is similar in many ways to that proposed by the Joint Working Group (JWG) in their draft standard on *Financial Instruments and Similar Items*. The

[1] Included as Appendix A.

staff notes that no substantive comments on the proposed definition were raised by respondents to the JWG draft standard.

Reasons for possible improvements to existing definitions

Reason One–Ownership Interests

8. IAS 32 *Financial Instruments: Presentation* defines *equity instruments* as **contracts** that evidence residual interests, which is intended to include contracts to deliver and exchange ownership interests. Two points arise from this:

    a. Ownership interests may not be contracts in all jurisdictions–for example, the U.S. Model Business Corporation Act is fairly clear that ownership interests are not contracts, but that contractual provisions may be associated with some types of shares, such as dividend preferences. Hence, non-contractual ownership interests may not be included at all.

    b. Contracts involving the delivery or exchange of ownership interests are included twice in the definition of a *financial instrument* – in the definition of an equity instrument as well as in the section on delivery and exchange contracts.

9. In contrast, Statement 107 refers to evidence of ownership interests with no reference to contracts.

10. The staff believes that the approach taken in Statement 107 is clearer and hence preferable. That is, to specifically include ownership interests, and include contracts requiring the delivery and exchange of ownership interests with other delivery and exchange contracts.

Reason Two - Symmetry of Contractual Rights and Obligations

11. IAS 32 states that a financial asset of one entity must be a financial liability or equity instrument of another entity. Statement 107 states that obligations under contractual financial assets create contractual financial liabilities.

12. This raises two issues:

a. Whether an instrument can be an asset to both parties, and

b. The interaction of rights and obligations that involve delivery (or exchange) of one's own equity with the definition of a financial instrument.

13. There have been prior debates about whether a financial instrument – such as a written option – can be an asset to both parties. Many written options are clearly liabilities for the writer, but some *may* create assets for the writer[2].

14. For example, a credit card company writes an option to the cardholder whereby the cardholder can borrow from the card issuer at any time, and the card issuer must extend credit to the cardholder if the option to borrow is exercised. Such a (renewable) written put option is a financial instrument.

15. Typically, (securities) options are only exercised when the strike price is more favorable to the option holder than the market price.

16. However, options to borrow using credit cards are often exercised when the interest rate exceeds the market rate on borrowings of similar terms from other sources, because of convenience and safety (that is, the card holder does not have to carry cash).

17. Such exercise of credit card options usually results in net economic benefit[3] to the card issuer. This is evidenced by the fact that the market is often willing to pay a premium for credit card receivables.

18. The second issue relates to the interaction of contractual rights and obligations that involve the delivery (or exchange) of one's own equity with the financial instruments' definition.

19. In Statement 107, a footnote to the definition of a financial instrument states that all contractual obligations that are financial instruments meet the Concepts Statement

[2] This series of papers does not attempt to answer, or even discuss in any detail, this issue. Paragraph 7 of Paper 4C suggests that the Boards defer any decision whether to include items such as credit card contracts in the scope of the DPD, until the discussion of the measurement issues arising from the written options in such contracts that is planned for a later meeting.

[3] There may also be additional income to the card issuer, including interchange and other fees.

No. 6 *Elements of Financial Statements* definition of liabilities and all contractual rights that are financial instruments meet the definition of assets (this would literally mean that all equity derivatives are assets and liabilities rather than equity, as some are classified under current GAAP).

20. To address these issues we could:

    a. Specifically include ownership interests with contracts requiring the delivery or exchange of ownership interests with other delivery and exchange contracts (as previously suggested in paragraph10), and

    b. State that the contractual obligation of one entity to deliver creates another entity's contractual right to receive, and that exchange contracts create rights and obligations for both parties.

Reason Three - Reference to Cash and Financial Instruments in Contracts That Are Financial Instruments

21. IAS 32 and Statement 107 explicitly refer to obligations to deliver cash or financial instruments and rights to receive cash or financial instruments – even though cash has previously been specified as a financial instrument.

22. The separate reference to cash is not needed.

Reason Four - Grouping of Delivery and Exchange Rights and Obligations

23. The definition in Statement 107 and IAS 32 group assets (rights to receive or exchange on favourable terms) separate from liabilities (obligations to deliver or exchange on unfavourable terms).

24. For example, IAS 32 states that:

> A *financial asset* is any asset that is: …
>
> (c) a contractual right:
>
> (i) to receive cash or another financial asset from another entity; or
>
> (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or …

A *financial liability* is any liability that is:

(a) a contractual obligation

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or…

25. Statement 107 states that:

A *financial instrument* is defined as … a contract that both:

(a) Imposes on one entity a contractual obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity

(b) Conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

26. Such an 'asset-liability' focus references the two parts of a single contract in different parts of the definition, which makes it more difficult to follow.

27. The staff believes that it is both clearer and more logical to group the two sides of the contract (the right and obligation to deliver or exchange) together. (Also note the following comments).

Reason Five - References to Favorable or Unfavorable Exchanges

28. IAS 32 and Statement 107 refer to exchanges of financial instruments under conditions (or, in Statement 107, terms) that are potentially favorable or unfavorable.

29. The reference to potentially favorable and unfavorable conditions (or terms) appears to exclude fair value contracts (such as a put option with a strike price of the market price on the exercise date) from meeting the definition of a financial asset and a financial liability. However, such contracts may have an asset value to one or both parties if (for example) the contract assures delivery.

30. Furthermore (as previously discussed) Statement 107 also requires that every asset is offset by a liability, and IAS 32 states that every contractual asset is offset by a contractual liability or equity instrument of another entity.

31. The reference to *favourable* and *unfavourable* is not required to ascertain whether something is an asset or a liability. The DPD could describe a financial asset as a financial instrument that is an asset (and similarly for a financial liability).

Reason Six - Right to Require Delivery or Exchange

32. IAS 32 and Statement 107 refer to the right to receive and the right to exchange.

33. It is actually the right **to require** receipt or exchange that creates a right to an economic resource, and hence creates an asset (rather then the ability to simply receive or exchange).

Reason Seven – Inclusion of Components of Non-Financial Contracts

34. In describing the one side of a delivery contract IAS 32 simply refers to a right to receive cash or another financial asset from another entity (or, in Statement 107, from the first entity).

35. One possible interpretation of this is that a component of an exchange contract (such as a forward) to buy or sell non-financial items meets the definition of a *financial instrument* delivery contract. That is, the contractual right of one party to receive cash or another financial instrument and the contractual obligation of another party to deliver cash or another financial instrument to the first party.

36. However, such an interpretation would ignore the fact that those rights and obligations are interdependent upon performance of the rights and obligations relating to delivery of the non-financial item[4].

37. The definition of a delivery contract could be improved by stating that the right to receive a financial instrument in a delivery contract is the only form of consideration to be received in exchange for releasing the other party from its obligation.

[4] During the deliberations that led to Statement 107, the FASB considered expanding the definition of a financial instrument to include such financial components of contracts that involve the delivery of goods or services. The FASB chose not to for various reasons, including questions regarding whether the fair value of the financial component should take account of changes in value caused by changes in the price of the underlying commodity.

Reason Eight – Multiple Element Contracts

38. IAS 32 and Statement 107 refer to contracts instead of contractual rights and obligations.

39. Such words imply that if a single contract contains two (or more) separate sets of **financial** rights and obligations, then the two sets of rights and obligations are one financial instrument[5].

40. The words also imply that an entire multiple element contract is a financial instrument, even if it contains both **financial** and **non-financial** rights and obligations.

41. An example of a multiple element contract is a contract that contains:

    a. A promise by which party A will construct a building for party B in return for later payment (a non-financial component), and

    b. A promise whereby party A agrees to lend money to party B so that party B can purchase fixtures and fittings from someone else (this would be a financial component).

42. The Boards could decide to consider such contracts as a whole, or alternatively consider each set of rights and obligations separately[6].

Considering multiple element contracts as a whole

43. Should the Boards decide that multiple element contracts should be considered as a whole, then the Boards will also need to decide whether to:

    a. Exclude any contract in its entirety from the scope of the DPD that includes a set of non-financial rights and obligations, or

[5] This series of papers do not address whether the Boards should permit or require contracts that contain a single set of rights and obligations that are within the scope of the DPD to be bifurcated. Furthermore, this series of papers does not address whether the Boards should permit or require sets of rights and obligations contained within multiple element contracts, in which all of the sets of rights and obligations are permitted or required to be measured at fair value under the DPD or other accounting literature, to be separately accounted for or whether the contract should be accounted for as a whole.

[6] The Boards will also need to consider how to treat multiple element contracts if a 'characteristics-based' approach (as outlined in Paper 4A) is used.

b. Include any contract in its entirety in the scope of the DPD that includes a set of financial rights and obligations.

44. Considering a multiple element contract as a whole is arguably simpler to implement than the alternative of considering individual sets of rights and obligations.

45. However, if the Boards decide that multiple element contracts should be viewed as a whole, then the consequence will be that some contractual rights and obligations will be accounted for differently if they form stand-alone contracts rather than being part of a multiple element contract.

46. In addition, should contracts that are excluded from the scope of the DPD contain certain sets of rights and obligations that the Boards wish to be accounted for similarly to financial instruments, there will need to be a mechanism to identify such rights and obligations and include them in the scope of the DPD (similar to the mechanism used today that is created by the definition of a derivative and the requirements surrounding the separate accounting of embedded derivatives).

Considering individual sets of contractual rights and obligations

47. Alternatively, the Boards could consider separately the individual sets of contractual rights and obligations that make up a multiple element contract. This was the approach taken in the FASB Preliminary Views on *Reporting Financial Instruments and Certain Related Assets & Liabilities at Fair Value* as well as the JWG document.

48. Such an approach would result in consistent treatment of rights and obligations that are the same, regardless of whether they are a standalone contract or are contained in a multiple element contract. All contractual rights and obligations that resulted in the delivery or exchange of a financial instrument (or possessed certain characteristics if the Boards chose such an approach to setting the initial scope, as was discussed in Paper 4A) would be included in the scope of the DPD.

49. This approach would also address multiple element contracts that the Boards may wish to exclude from the scope (such as insurance contracts), but that may contain rights and obligations that the Boards wish to be included in the scope of the DPD[7].

Other possible approaches

50. Other possible approaches that the Boards might consider include:

    a. Assessing multiple element contracts using a predominant characteristics basis (and whichever characteristics dominate drives the classification of the contract), or

    b. Assessing multiple element contracts based on the relationship between the different sets of rights and obligations. Therefore, if the financial set of rights and obligations were ‘closely’ related to the non-financial rights and obligations in the contract, the whole contract would be outside the scope of the DPD. Or, alternatively, if everything in the contract were closely related to the financial portion, then the whole contract would be in the scope.

51. However, such approaches (as well as having significant implementation issues) could result in:

    a. Contractual rights and obligations in standalone contracts being accounted for differently than identical rights and obligations included in other contracts, and

    b. Contractual rights and obligations that would otherwise be included in the scope being excluded if they were not predominant. Alternatively, contractual rights and obligations being included in the scope that would not be within the scope if they were assessed separately.

[7] The staff notes that there are various issues relating to the feasibility of requiring bifurcation of contracts based on contractual rights and obligations. For example, the FASB Invitation to Comment on the *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting* asks for views regarding possible bifurcation of insurance contracts into components that transfer significant insurance risk and are accounted for as insurance and financing components that are accounted for as deposits.

52. These issues are similar to those raised previously in relation to considering a multiple element contract as a whole.

53. **Questions to the Boards:**

   a. **Do you want to view multiple element contracts:**

      i. **as a whole,**

      ii. **as separate sets of rights and obligations, or**

      iii. **using an alternative approach? If so, which approach?**

   b. **If you want to view multiple element contracts as a whole, then do you want to:**

      i. **Exclude any contract in its entirety from the scope of the DPD that includes a set of non-financial rights and obligations, or**

      ii. **Include any contract in its entirety in the scope of the DPD that includes a set of financial rights and obligations.**

   c. **If you are not prepared to answer these questions yet, what additional information do you need?**

APPENDIX A

IAS 32 *Financial Instruments: Presentation*

11 The following terms are used in this Standard with the meanings specified:

A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A *financial asset* is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

   (i) to receive cash or another financial asset from another entity; or

   (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

A *financial liability* is any liability that is:

(a) a contractual obligation

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Statement of Financial Accounting Standards No. 107 *Disclosures about Fair Value of Financial Instruments*

3. A financial instrument is defined as cash, evidence of an ownership interest in an entity, or a contract that both:

(a) Imposes on one entity a contractual obligation[1] (1) to deliver cash or another financial instrument[2] to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity

(b) Conveys to that second entity a contractual right[3] (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

[The footnotes explain that: (1) the contractual rights and obligations referred to may be conditional and the word *entity* is used to include groups of entities, (2) although the definition of a financial instrument includes the word financial instrument, it is not circular because at some point in a chain of financial instruments one party pays the other cash or an equity instrument, and (3) all of the contractual obligations meet the definition of a liability, and all of the contractual rights meet the definition of an asset]