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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 – Possible adjustments to the initial scope (Agenda Paper 4C)**

PURPOSE OF THIS PAPER

1. This paper discusses possible adjustments to the scope of the DPD.

2. Such adjustments may:

    a. Exclude certain items (which may either meet the definition of a *financial instrument* or possess certain characteristics).

    b. Include certain items (that either do not meet the definition of a *financial instrument* or do not possess certain characteristics), but that are difficult to distinguish from contracts that do.

POSSIBLE ITEMS TO EXCLUDE FROM THE DPD SCOPE

3. The Boards should explicitly consider whether to exclude (or include) the following items from the scope of the DPD:

    a. Investments in consolidated subsidiaries, consolidated variable interest entities (FASB only), and associates (equity method investees in FASB terms) or joint ventures

    b. Contingent consideration in business combinations

    c. Leases

    d. Royalty contracts and other contracts for rights to use assets (revenue recognition issues)

    e. Pensions and other post employment benefits

    f. Financial instruments classified as equity by the reporting entity

    g. Insurance and related contracts

    h. Financial instruments and derivatives related to share-based payments

    i. Contracts that are financial instruments by definition but are not recognized under current GAAP

    j. Other strategic investments

    k. Inter-group balances

4. Categories (a)–(g) in paragraph 3 include financial instruments, items very similar to financial instruments, or both that the Boards have considered to be sufficiently different from financial instruments in general to address in other projects currently on their agendas. Addressing them in an active project while at the same time including them in the scope of a DPD on financial instruments is likely to cause confusion among constituents about the Boards' intentions.

5. Drafting a precise description of the items in Categories (d)—royalties and contracts for the right to use assets—and (g)—insurance and related contracts—might pose significant drafting issues if the DPD were an Exposure Draft or final Standard. However, since it is an early stage document, we can describe the Boards' intentions in general terms and ask for constituents' input on how to describe those categories more precisely.

6. Category (h)—financial instruments and derivatives related to share-based payments—includes items that are likely to be highly controversial if included in the DPD. The Boards should consider whether that type of controversy will attract so much attention that constituents will not provide the types of comments on other instruments that the Boards need in the next stages of the broader project on financial instruments.

7. Category (i)—contracts that are financial instruments by definition but are not recognized under current GAAP—includes such items as loan commitments, lines of credit, credit card contracts, and other financial instruments that are not currently required to be recognized except, for example, in business combinations or when an entity has incurred a loss related to them. There may be no good reason to exclude them from the scope of the DPD. However, the staff suggests that the Boards defer any such decision until the discussion of the measurement issues arising from the written options in such contracts that is planned for a later meeting.

8. Category (j)—other strategic investments—refers to those investments (other than those already described in category (a)) made in the ownership interests of another entity with the intention of establishing or maintaining a long-term operating (strategic) relationship with that other entity. It is argued by some that such an investment contains some non-financing rights in addition to those rights associated with the financial instrument itself and hence such investments should be accounted for differently. The Boards should consider whether such investments in the ownership interests of another entity contain any additional rights in comparison to other investments in ownership interests.

9. Category (k)—inter-group balances—some argue that inter-group balances (such as receivables and payables) should be excluded from the scope of any standard on financial instruments for the purposes of separate or individual financial statements because such items may not be subject to arm's-length valuation or may be more in the nature of equity instruments. (In some jurisdictions such statements may play an important role in determining tax or distribution to shareholders). The Boards should consider whether such instruments are fundamentally different than any other financial instrument.

10. Questions to the Boards:

   a. Which, if any, of the items listed in paragraph 3 should be excluded from the scope of the DPD?

   b. If you are not prepared to answer that question yet, what additional information do you need?

POSSIBLE ITEMS TO INCLUDE IN THE DPD SCOPE

11. The staff has identified the following three broad categories of contracts that are not financial instruments by definition, but that the Boards should consider including in the scope of the DPD:

   a. Contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument,

   b. Financial instrument servicing contracts, and

   c. Other contracts to deliver/exchange products or services that are otherwise similar to financial instrument contracts.

Contracts to Buy or Sell a Non-financial Item that Can Be Settled Net in Cash or Another Financial Instrument

12. Paper 4A identified the characteristic that such contracts have in common with a financial instrument – that of a similar probable outcome. If a definition based

approach is used in setting the initial scope of the DPD, the Boards need to decide whether to include such contracts within the scope of the DPD.

Financial Instrument Servicing Contracts

13. Paper 4A also discussed financial instrument servicing contracts. Such contracts are treated under U.S. GAAP similarly to financial instruments, but do not have a similar probable outcome to financial instruments.

14. As discussed in that paper, it may be possible to infer a principle-based approach to the inclusion of such contracts in the scope of the DPD, although possible principles may result in either all contracts or only financial instrument servicing contracts being in the scope of the DPD.

15. It may therefore be preferable to separately specify the inclusion of financial instrument servicing contracts (which, despite the cash flows associated with servicing a financial instrument being an inherent part of a financial instrument, only arise when a separate contract to service a financial instrument is entered into) in the scope of the DPD.

Other Contracts to Deliver/Exchange Products or Services That Are Otherwise Similar to Financial Instrument Contracts

16. For certain non-financial contracts, it is difficult to identify any significant differences from financial instrument contracts apart from the requirement to deliver/exchange products or services. Such contracts include some credit card agreements issued by retailers and insurance policies and warranty agreements that result in the delivery or exchange of products or services.

17. For example, some insurance policies and warranty agreements may not require the delivery of cash to the policyholder if an insurer pays a third party that provides goods or services[1]. To many constituents (and Board members), that will not seem like a significant economic difference from contracts that meet the definition of a *financial instrument.* (This issue was raised by some respondents

[1] If the Boards decide to exclude insurance contracts from the scope of the DPD, this issue is not relevant.

to the FASB proposed statement on *The Fair Value Option for Financial Assets and Financial Liabilities)*.

18. The Boards could include such contracts in the scope of the DPD because of their apparent similarity to financial instruments. However, because this issue is so closely associated with the core of the definition of a contractual financial instrument (that is, the requirement to deliver/exchange another **financial instrument**) it would be challenging (if at all possible) to design a requirement that would be specific enough to include such contracts, but to exclude other types of nonfinancial contracts. Many other arrangements to sell goods or services would appear to be similar (if not the same) as, for example, an insurance contract to deliver goods or services to a policyholder.

19. **Questions to the Boards:**

    a. **Should net settleable contracts (paragraph 12), financial instrument servicing contracts (paragraphs 13–15), or contracts that are very similar to related financial instrument contracts (paragraphs 16–18) be included in the scope of the DPD?**

    b. **Are there other categories of contracts that should be considered for inclusion in the scope of the DPD?**

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