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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IASB Meeting:	**Financial Instruments Working Group**
Paper:	**Agenda Paper 8A**

Financial Instruments: Due Process Document (DPD)

Approaches to setting the initial scope and a proposed definition of a 'financial instrument'

BACKGROUND TO PAPER 8A AND 8B

1. Papers 8A and 8B discuss how the initial scope of the fair value model should be set.

2. The scope of IAS 39 *Financial Instruments: Recognition and Measurement* is based on a definition of a *financial instrument.* That scope is then adjusted. Some of those adjustments result in the inclusion of certain contracts to buy or sell non-financial items. Such contracts do not meet the definition of a *financial instrument.*

3. Therefore an initial scope based on the definition of a *financial instrument* does not fully capture all of the contractual rights and obligations that (it has been felt historically) should be within the scope of a financial instruments' accounting standard. Furthermore, such adjustments add complexity.

POSSIBLE ALTERNATIVE METHODS OF SETTING THE INITIAL SCOPE

4. There are a number of different ways to set the initial scope of the fair value model. These include the following approaches:

    a. An initial scope of all contractual rights to receive and obligations to deliver an item, regardless of what that item may be.

    b. An initial scope that is a definition of *financial instruments.*

    c. An initial scope that is broader than a definition of *financial instruments*

5. The approach of including **all** contractual rights to receive and obligations to deliver an item, regardless of what that item might be seems to be a more natural starting point than a definition of *financial instruments*. However such a scope would be too broad to be acceptable to either of the Boards or their constituents and so this paper does not consider it further.

6. This paper discusses using a revised definition of a *financial instrument* as the initial scope for a fair value model, and possible reasons to change existing definitions of *financial instruments*.

7. Paper 8B discusses setting an initial scope that is broader than a definition of *financial instruments*.

A DEFINITION OF *FINANCIAL INSTRUMENTS*

Why change existing definitions?

8. The two Boards could choose to use their separate existing definitions[1] due to constituent familiarity with them.

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

[1] Included in Appendix A.

Proposed definition

10. The draft definition of a *financial instrument* 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.

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

Principal reasons to improve existing definitions

Reason One – Ownership Interests

12. 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.

13. In contrast, Statement No. 107 *Disclosures about Fair Value of Financial Instruments* refers to evidence of ownership interests with no reference to contracts.

14. 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

15. 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.

16. 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.

17. 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. This issue is discussed in detail in paper 8D.

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 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 contracts requiring the delivery or exchange of ownership interests with other delivery and exchange contracts (as previously suggested in paragraph 14), 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 – Grouping of Delivery and Exchange Rights and Obligations

21. The definitions in Statement 107 and IAS 32 groups assets (rights to receive or exchange on favourable terms) separately from liabilities (obligations to deliver or exchange on unfavourable terms).

22. 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…

23. 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.

24. 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.

25. 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 Four – References to Favorable or Unfavorable Exchanges

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

27. 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.

28. Furthermore (as previously discussed) Statement 107 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.

29. 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 Five –Components of Non-Financial Contracts

30. 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).

31. 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.

32. 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[2].

33. 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.

[2] 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 Six – Multiple Element Contracts

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

35. 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[3].

36. 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.

37. 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).

38. Such contracts could be considered as a whole. Alternatively each set of rights and obligations could be considered separately.

Considering multiple element contracts as a whole

39. If multiple element contracts were considered as a whole, then we would need to determine whether:

[3] This paper does not address whether contracts that contain a single set of rights and obligations that are within the scope of the DPD should be permitted or required to be bifurcated. Furthermore, this paper does not address whether 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, should be permitted or required to be separately accounted for or whether the contract should be accounted for as a whole.

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

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

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

41. However, if multiple element contracts are viewed as a whole, then the consequence may 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.

42. In addition, should contracts that are excluded from the scope of the DPD contain certain sets of rights and obligations that it is considered should accounted for similarly to financial instruments, a mechanism will be needed to identify such rights and obligations and include them in the scope of the DPD. This could be similar to the mechanism used today of identifying and separately accounting for embedded derivatives in contracts that are not financial instruments.

Considering individual sets of contractual rights and obligations

43. Alternatively the individual sets of contractual rights and obligations that make up a multiple element contract could be considered individually. 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.

44. 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 approach to setting the initial scope discussed in Paper 8B was used) would be included in the scope of the DPD.

45. This approach would also address multiple element contracts that may be excluded from the scope (such as insurance contracts), but that may contain rights and obligations that should be included in the scope of the DPD[4].

46. The draft definition of a *financial instrument* set out earlier in this paper is based on this approach.

Other possible approaches

47. Other possible approaches 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. Alternatively, all components of the contract were closely related to the financial portion, the entire contract would be in the scope.

48. 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,

[4] 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.

contractual rights and obligations being included in the scope that would not be within the scope if they were assessed separately.

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

50. **Questions to the members:**

   a. **Should the existing definitions of a financial instrument be changed for the purpose of the DPD?**

   b. **If so, do you agree with the proposed changes and the reasons for the proposed changes? If not, why not?**

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]