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International Accounting Standards Board

INFORMATION FOR OBSERVERS

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

Financial Instruments: Due Process Document (DPD)

An initial scope that is broader than the definition of a *financial instrument*

BACKGROUND

1. This paper continues the discussion as to how the initial scope of a fair value model should be set.

2. Paper 8A discussed an initial scope that is a (revised) definition of *financial instruments.*

3. This paper discusses an initial scope that is broader than a definition of *financial instruments*.

4. Setting an initial scope broader than *financial instruments* would have the objective of avoiding creating a subsequent list of other items to include related or similar contracts.

5. In order to be able to identify a principle-based scope that is broader than the definition of a *financial instrument*, one place to start is to understand the characteristics of those contracts currently accounted for similarly to financial instruments (in IFRS*)* or as derivatives (in U.S. GAAP) – and how those characteristics are similar to the characteristics of contracts that **do** meet the definition of a *financial instrument*.

CHARACTERISTICS OF FINANCIAL INSTRUMENTS

6. To identify the similarities between financial instruments and other contracts, it is necessary to first consider the characteristics of financial instruments.

7. As discussed in paper 8A there are three types of financial instruments – cash, ownership interests, and certain contracts.

8. As this paper seeks to identify similarities with other types of contracts that are currently accounted for similarly to financial instruments, it focuses on the characteristics of **contractual** financial instruments.

9. As noted in paper 8A, 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). 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 services)[1].

b. Exchange contracts require (a) one party to deliver to the counterparty cash, an ownership interest or a contractual financial instrument, and (b) a right of that party to receive from the counterparty cash, an ownership interest, or a contractual financial instrument.

10. 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 contracts that ultimately require delivery of cash or ownership interests (but nothing else). For example, a forward contract to purchase government bonds requires delivery of cash against exchange of the bond. The bond itself also eventually contractually results in cash being delivered (through interest and principal repayments) by the government to the holder of the bond.

11. 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. That is, the outcome of the contract (or ultimate contractual outcome) is cash or ownership interests.

CHARACTERISTICS OF CONTRACTS ACCOUNTED FOR SIMILARLY TO FINANCIAL INSTRUMENTS OR DERIVATIVE INSTRUMENTS

12. Contracts that are not financial instruments but that are currently 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

[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.

which an outcome similar to that of a financial instrument is probable. In other words, the probable outcome of such contracts is the realization of cash or ownership interests.

13. 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.

14. Taking intent first, an entity demonstrates its intent by not electing, or qualifying for, the ‘normal’ purchase or sale exceptions in IAS 39 and Statement 133.

15. Turning to ability, IAS 39 and Statement 133 set out various ways in which ability to net settle or sell the underlying item 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 of the underlying and selling it 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 for the subject of the contract).

16. The contractual net settlement option is very similar to the contractual outcome of a financial instrument. A past practice of taking delivery of the underlying and selling in a short period is not as similar to the contractual outcome of a financial instrument.

17. However, any of the ways set out in paragraph 15, when combined with management intent, result in a probable similar outcome to the contractual

outcome of a financial instrument; that is, the probable outcome of the contract is the ultimate realization of cash or ownership interests.

18. 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 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 methods used to measure financial instruments.

19. 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.

20. 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; that is, financial instruments and contracts with the same probable outcomes.

21. This could, of course, potentially result in a wide initial scope where only exchange contracts that met something similar to the normal purchase/sale exemption we have in current GAAP would be excluded.

22. Related to this, a key question to be addressed is: how probable must it be that the outcome of a contract will be the same as that of a financial instrument? The outcomes in all of the examples previously discussed are highly probable (although it is not possible to assign a percentage).

WHAT ABOUT NON-CONTRACTUAL ITEMS?

23. This paper has so far discussed **contracts** that have similar probable outcomes to a financial instrument contract.

24. Another possible approach might be to consider non-contractual items that have similar probable outcomes to contractual financial instruments.

25. For example, natural gas inventory might be considered similar to a prepaid forward purchase contract for natural gas that will be net settled. They both have similar fair values and, if the inventory is held for trading, the inventory will also result in the realization of cash. Other items to consider might include intangibles such as emission allowances that may be traded or used to buy items or pay obligations.

WHAT ABOUT FINANCIAL INSTRUMENT SERVICING CONTRACTS?

26. Financial instrument servicing contracts[2] 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

[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.

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 that are 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.

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 FIWG members:**

a. **Should the initial scope of the fair value model be based on contracts that have a probable outcome of the realization of cash or ownership interests? If not, do members have any alternative principle based approaches that could be used to set the initial scope?**

b. **If the initial scope was based on contracts that have a probable outcome of the realization of cash or ownership interests, what application or other issues would have to be addressed?**