FINANCIAL INSTRUMENTS FACT SHEET #1

ACCOUNTING STANDARDS BOARD

APPLYING THE DEFINITION OF FINANCIAL INSTRUMENTS		
What is the definition of a financial instrument?	*Definition* A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or a residual interest of another entity. *Interpretation* The characteristics that are important for assessing whether an instrument is a financial instrument or not are as follows: • The arrangement is contractual rather than a statutory arrangement (i.e. those that arise from legislation, regulation or equivalent). • One party to the transaction has a financial asset, and the other party to the transaction has either a financial liability or a residual interest ('equity').	Paragraph 2.1
What is the definition of a financial asset?	*Definition* Definition A financial asset is: (a) cash; (b) a residual interest of another entity; or (c) a contractual right to: (i) receive cash or another financial asset from another entity; or (ii) exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity. *Interpretation* Some aspects to consider: • Cash – whether in an entity's bank account, monetary instruments (e.g. cheques, postal orders) and/or physical cash (notes and coins) - is a financial asset. • For an asset to be a financial asset, the transaction must be settled through the receipt of cash or another financial asset and not through the receipt of goods or services.	Paragraph 2.1, and AG2.1
What is the definition of a financial liability?	*Definition* A financial liability is any liability that is a contractual obligation to: (a) deliver cash or another financial asset to another entity; or (b) exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity. *Interpretation* For a liability to be a financial liability, the transaction must be settled through the payment of cash or another financial asset and not through the provision of goods or services.	Paragraph 2.1 and 3.5-3.8

This Fact Sheet explains the Secretariat's views on the possible accounting treatment of public sector transactions based on the principles in GRAP 104 on Financial Instruments (revised in 2019). This Fact Sheet accompanies, and is not a replacement for, the complete text of GRAP 104 Financial Instruments. The Fact Sheet outlines the most common features and accounting considerations related to a particular transaction. The accounting may differ depending on the facts and circumstances of individual arrangements. This Fact Sheet has not been reviewed, approved or otherwise acted on by the ASB.

What does a 'contract' mean?	Contracts are evidenced by the following three criteria: (a) contracts involve willing parties entering into an arrangement; (b) the terms of the contract create rights and obligations for the parties to the contract, and those rights and obligations need not result in equal performance by each party; and (c) performance and remedy for non-performance are enforceable by law.	Paragraph AG2.11-AG2.13
Can financial instruments be non-exchange transactions?	Yes. It is important that both parties have rights and obligations to the arrangement. It is not necessary that the rights and obligations are of equal value. Where the value of the rights and obligations are not equal this could be a non-exchange transaction.	Paragraph AG2.12
What are common mistakes entities make in classifying transactions as financial instruments?	The examples discussed below reflect common transactions that are often incorrectly classified as financial assets or financial liabilities, or where the classification may be subjective. Where the classification may be subjective, an entity applies judgement to decide if the asset or liability is a financial instrument based on the specific facts and circumstances. The conclusions reached below are based on the specific patterns illustrated. Where there is no specific guidance on a transaction in GRAP 104, the scenarios below have been analysed using the following criteria: • Is the arrangement contractual? • Will the transaction be settled in cash or another financial asset? • Does the arrangement give rise to a financial asset in one entity and a financial liability or residual interest in another?	
	Consumer deposits *Background* Municipalities may request consumers to pay a deposit when opening an account for the supply of goods or services. The deposits could represent an advance receipt for the supply of goods or services (i.e. a prepayment), or collateral for potential defaults on future debts. The terms and conditions of each arrangement should be analysed to understand why the deposit is held. The accounting treatment may also change if the terms and conditions of the arrangement, and/or the entity's intention changes. *Analysis* • The arrangement is contractual as the consumer willingly enters into an arrangement for the supply of services from the municipality, and rights and obligations are provided for both the municipality (provide services on credit) and the consumer (pay for services received). • Whether the arrangement will be settled in cash or not requires judgement. If the consumer deposit will be returned when the account is closed (or in some other circumstance) the transaction is settled in cash. If the deposit will be used to offset the final account of the consumer an entity considers if it should apply the offsetting principles. An entity can offset an asset and a liability	Paragraph 7.9-7.17 and AG8.38-8.51

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	when there is (a) a legally enforceable right to set off amounts recognised, *and* (b) the entities intend to settle on a net basis or realise the assets and liabilities simultaneously. If the transaction does not meet the offsetting requirements, then it is accounted for as two separate transactions, and it is likely that the transaction will be settled through the provision of goods and services rather than cash. • Whether there is a financial asset and a financial liability for either party will depend on the analysis in the preceding point. *Conclusion* The arrangement could be a financial liability of the municipality. An assessment needs to be made of why the deposit is held and how it will be used or returned to the consumer. Although this example focuses on the entity as the holder of the consumer deposit, a similar principle could be applied if the entity has paid a deposit to another party. The example could also be applied by other entities that hold deposits (if they arise from contracts).	
	Assets seized for defaults on debts owing to the entity *Background* Entities often hold collateral over non-financial assets for the settlement of debts owing to the entity. The entity may seize the assets in the event of default. *Analysis and conclusion* The initial transaction may meet the definition of a financial instrument. The subsequent decision to change the manner of settlement (which may also include that the seizure is undertaken in terms of a court order) changes the nature of the instrument from a financial asset to another asset.	Paragraph 6.5(b)
	Employee benefits *Background* Employees provide services to entities in return for specific benefits. The benefits are often paid over time. Benefits can be either short term or long-term benefits. *Analysis and conclusion* The payment of employee benefits is outside the scope of GRAP 104 and is accounted for using GRAP 25 on *Employee Benefits.*	Paragraph 1.2(b)
	Bursaries *Background* Entities provide bursaries to employees to further their studies. The terms often indicate that the arrangement is a bursary, but if the employee is not successful (in full or in part) with his/her studies, then the employee is required to repay the financial support received (in full or in part).	

	Analysis • The arrangement is contractual as the parties willingly enter into the arrangement, and rights and obligations exist for both parties (entity to provide financial support, employee to successfully pass studies). • The entity has a contractual obligation based on the terms and conditions in the arrangement. • If the employee is unsuccessful in his/her studies, the entity has a right to receive cash from the employee. Prior to this, the entity does not have an unconditional right to receive cash. *Conclusion* • The initial recognition of the obligation and expense is a financial liability. It is however not dealt with in GRAP 104 as this is an employee benefit in the scope of GRAP 25. • The right to receive resources from the employee is a financial asset as the transaction will be settled in cash and therefore gives rise to a financial asset for the entity and a financial liability for the employee. This transaction is in the scope of GRAP 104. Note: The initial employee benefit expense recognised in the statement of financial performance may need to be adjusted for the full or partial re-imbursement of the resources provided.	
	VAT receivable or payable *Background* Entities that are VAT vendors are either obligated to pay or entitled to receive the net VAT on taxable goods and services to/from SARS. *Analysis* VAT receivable or payable is governed by the VAT Act. As a result, the arrangement is a statutory rather than a contractual arrangement. *Conclusion* VAT receivable or payable is not a financial instrument as it does not arise from a contractual arrangement. An entity considers if GRAP 108 on *Statutory Receivables* or another Standard of GRAP is appropriate.	
	Prepayments or advance receipts *Background* Entities may pay for certain goods or services in advance (e.g. insurance) or may receive resources in advance of providing goods or services (Note: it is assumed that the prepayment or advance is not refundable). *Analysis* • As prepayments and advances could relate to various goods or services, an entity will need to assess if the arrangement is contractual or statutory in nature.	Paragraph AG2.9

	• If the prepayment or advance is for goods and services, then the transaction will be settled through the receipt or provision of goods or services and not cash or another financial asset. • As the transaction will not be settled in cash or another financial asset, there is no financial asset or financial liability for either party. *Conclusion* Prepayments or advances for the receipt or provision of goods or services are not financial instruments. An entity develops its own accounting policies using the principles in Standards of GRAP that deal with similar issues or the *Framework for the Preparation and Presentation of Financial Statements*.	
	Leases Finance lease receivables and financial lease liabilities are financial instruments because they represent an unconditional contractual obligation to receive or pay cash. Operating lease receivables or payables are only financial instruments when the conditions of the lease have been fulfilled and the parties are entitled to receive or obligated to pay cash or another financial instrument. Lease receivables are subject to the impairment, derecognition and presentation requirements of the Standard, while lease payables are subject to the derecognition and presentation requirements.	Paragraph 1.3(c) and AG2.7
	Debtors with credit balances or creditors with debit balances As the circumstances that led to a debtor with a credit balance or a creditor with a debit balance, an entity should understand the reasons why this occurred. The terms and conditions of the arrangement between the parties should be examined to understand if there are any specific requirements that may need to be followed when this occurs. If the transaction will be settled by paying or receiving cash or another financial asset, then it may be a financial instrument.	