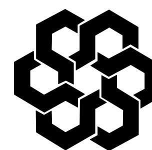

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International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting:	**2 November 2006, London**
Project:	**Review of published tentative agenda decisions**
Subject:	**IAS 39 *Financial Instruments: Recognition and Measurement*: Definition of a derivative - Indexation on own EBITDA or own revenue (Agenda Paper 7(v))**

Tentative agenda decision published in July-2006 IFRIC Update

The IFRIC was asked to provide guidance on the definition of a derivative in paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement*.

Paragraph 9 of IAS 39 excludes from the definition of a derivative those contracts whose value changes in response to changes in a non-financial variable that is specific to a party to the contract. The exclusion was introduced by IFRS 4 *Insurance Contracts* to help distinguish insurance contracts from financial instruments.

This had led some to conclude that the exclusion in paragraph 9 for non-financial variables that are specific to a party to the contract applies only to insurance contracts.

The IFRIC noted that there is no explicit statement within the Standard that the exception in paragraph 9 of IAS 39 applies only to non-financial variables that are the subject of insurance contracts.

The IFRIC believed that the exclusion in paragraph 9 of IAS 39 for non-financial variables that are specific to a party to the contract is not restricted to insurance contracts. The IFRIC did not expect significant diversity in practice and therefore [decided] not to add this issue to its agenda.

The IFRIC was also asked to provide guidance on whether a contract that is indexed to an entity's own revenue or own earnings before interest, tax, depreciation and amortisation (EBITDA) meets the definition of a derivative under IAS 39.

As noted above, paragraph 9 of IAS 39 excludes from the definition of a derivative those contracts whose value changes in response to changes in a non-financial variable that is specific to a party to the contract. The IFRIC was, therefore, asked for guidance on whether revenue or EBITDA are financial or non-financial variables.

The IFRIC accepted that it is unclear from the Standard whether revenue or EBITDA are financial or non-financial variables. However, [the IFRIC decided] not to take this issue on to its agenda as it believed it would be unable to reach a consensus on a timely basis.

Deloitte.

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25 September 2006

Robert Garnett, Chairman
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Email: ifric@iasb.org

Dear Bob,

Proposed rejection wording: IAS 39 *Financial Instruments: Recognition and Measurement*: Definition of a derivative - Indexation on own EBITDA or own revenue

Deloitte Touche Tohmatsu is pleased to respond to IFRIC's publication in the July 2006 *IFRIC Update* of the tentative decision not to take onto the IFRIC agenda a request for an interpretation of the definition of a derivative in the case of contracts linked to own EBITDA or own revenue.

We have a number of major concerns with the proposed rejection hence do not support the proposed rejection wording. The proposed rejection has far reaching consequences for the recognition and measurement of financial and non-financial contractual arrangements. We believe the IFRIC must firstly understand the Board's intention when it amended IAS 39 when IFRS 4 was issued. In addition, guidance must be provided on what is a financial and non-financial variable so users can apply this amended definition of a derivative.

Our first major concern is that IFRIC has only rejected half of the question on technical grounds. The IFRIC states that the amendment to the definition of a derivative is not restricted to scoping out insurance contracts from IAS 39. However, the IFRIC has not provided any guidance on determining what a non-financial or financial variable is in the definition. Entities that currently classify a contractual arrangement as a derivative measured at fair value through profit or loss now need to apply a restricted definition of a derivative and may be required to derecognise or re-measure these instruments. An

entity can only make the assessment of whether their contract is a derivative or not if it has guidance as to what a financial and non-financial variable is. The unintended consequence of IFRIC's inability to reach a decision or provide guidance will be to create divergence in practice.

We do accept there was no explicit statement that the amendment to the definition of a derivative arising from the issue of IFRS 4 was designed solely to exclude insurance contracts, but equally, there is no evidence that the Board intentionally wished to change the scope of IAS 39 as part of its insurance project. Determining what are financial and non-financial variables is relevant in applying IFRS 4, which defines insurance risk as a "risk, other than financial risk", and the definition of financial risk states that "provided in the case of a non-financial variable that the variable is not specific to a party to the contract". It stands to reason that as financial and non-financial risks are fundamental in determining whether a contract is an insurance contract or not, that the introduction of these words into the definition of a derivative was specifically to address this. To suggest otherwise is to contend that the intention and effect of the amendment to the definition of a derivative was to alter the recognition and measurement requirements for instruments (such as debt contracts with payments linked to EBITDA or own revenue) that clearly do not have characteristics of an insurance contract. We believe there is no evidence to suggest that the intention of the amendment was to prevent such features meeting the definition of a derivative. Indeed the text of IAS 39:AG 12A explains the application of the change to the definition solely by reference to an example of an insurance contract. We believe IFRIC's view is at odds with IAS 39:IG B8 and IAS 39.AG33f(ii) which clearly indicate that derivatives can be based on sales volumes, and thus revenue, which many would consider to be non-financial variables.

We also note that IFRS 4.B19 contains, among other examples, a contract that is not an insurance contract:

> *(e)* *derivatives that expose one party to financial risk but not insurance risk, because they require that party to make payment based solely on changes in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable,* ***provided in the case of a non-financial variable that the variable is not specific to a party to the contract [emphasis added]***

This suggests that financial risk (and thus also the definition of a derivative) and insurance risk are defined in opposition to one another. The following section of the Basis of Conclusions to IFRS 4 also suggests that the insertion of the phrase "non-financial variable not specific to a party to the contract" into the definition of financial risk (and by implication the change to the definition of a derivative) was connected with the notion of an insurable event and insurance contracts:

> *BC26* *Because the definition proposed in the Issues Paper did not include a notion of insurable interest, it would have encompassed gambling. Several commentators on the Issues Paper stressed the important social, moral, legal and regulatory differences between insurance and gambling. They noted that policyholders buy insurance to*

> *reduce risk, whereas gamblers take on risk (unless they use a gambling contract as a hedge). In the light of these comments, the definition of an insurance contract in the IFRS incorporates the notion of insurable interest. Specifically, it refers to the fact that the insurer accepts risk from the policyholder by agreeing to compensate the policyholder if an uncertain event adversely affects the policyholder.* ***The notion of insurable interest also appears in the definition of financial risk, which refers to a non-financial variable not specific to a party to the contract. [emphasis added]***

In recent months, the IFRIC has put two issues to the Board in order for the IFRIC to understand the Board's intention when they finalised the relevant standard. The first example was "indirect obligations" (commonly referred to as "economic compulsion") in IAS 32 and the second was the meaning of "groups of similar assets" in the derecognition guidance in IAS 39. Understanding the intention of the Board in amending IAS 39 when IFRS 4 was finalised is critical in answering this issue. We do not understand why indirect obligations and groups of similar of assets have been referred to the Board but the definition of a derivative has not. We urge the IFRIC, at a minimum, to refer this issue to the Board and bring their conclusion back to IFRIC for discussion before concluding on a proposed rejection wording or issuing an interpretation.

Our second major concern is that this rejection will have far reaching consequences for the recognition and measurement of both financial and non-financial contractual arrangements. We note that the submission to IFRIC was purposely broad, with EBITDA/revenue linked debt used merely as illustration. Consider the following examples:

- Debt with interest linked to own EBITDA/revenue. Prior to any IFRIC rejection notice interest on the debt host contract will be recognised at a normal market interest rate and an embedded derivative recognised for the linkage to own EBITDA/revenue. Following a final IFRIC rejection notice, if EBITDA/revenue is considered non-financial, an embedded derivative will not be recognised, and the issuer will need to apply IAS 39:AG8 to determine the carrying value of the debt. The issuer will need to reassess the expected profits and discount them back at the original effective interest rate each period. This would be a significant change to the measurement of the instrument and recognition of interest if the rejection notice is made final.

- A physical gas supply contract where the amounts paid are based on a basket of indices. Previously, if the indices were not closely related to the economic characteristics and risks of the host, i.e. the price normally paid to purchase the non-financial item, in this case gas, an embedded derivative would have to be separated and measured as at fair value through profit or loss. As the definition of a derivative does not state that the variable has to be specific to the non-financial item subject to the contract, only that it has to be specific to the entity or the counterparty, any index that is considered to be specific to that entity or the counterparty, e.g. sales of a different item, volume of sales, costs of other goods acquired, net profit, will now not be separately recognised as an embedded derivative. The whole arrangement will now not be accounted for

until delivery. IFRIC's view will result in structuring opportunities as derivatives can be concealed in physical delivery contracts and not be separately accounted as embedded derivatives. We find this perverse when IAS 39:BC37 states that the *"rationale for the embedded derivatives requirements is that an entity should not be able to circumvent the recognition and measurement requirements of the derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract…"*

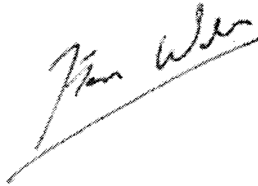
- An entity enters into a standalone derivative, say a swap, linked to the counterparty's net profit. If net profit is considered non-financial the instrument cannot be a derivative. If the instrument is not intended to be traded in the short-term it cannot be held-for-trading. The remaining financial asset categories of loan and receivable, held-to-maturity, and available-for-sale financial asset appear inappropriate for an instrument that depending on market movements could be an asset one day and a liability the next. If the instrument was a liability, as it is not held-for-trading, the instrument would be measured at amortised cost. We cannot believe it was the Board's intention to measure derivative assets at either amortised cost or fair value through equity and derivative liabilities at amortised cost. IFRIC's proposed rejection leaves a gaping hole in recognition and measurement for contracts that are clearly financial instruments within the scope of IAS 39.

- An entity enters into a contract to buy a non-financial item, say gold. As the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price, the instrument is in the scope of IAS 39 because of paragraph 6(c). Following the IFRIC rejection the entity could claim that the market price of gold is a non-financial variable that is specific to a party to the contract (either specific to the entity as it is a buyer and seller of gold, or the counterparty because it is a gold producer). This would result in executory contracts that were intended to be scoped into IAS 39 as derivatives now no longer being measured as at fair value through profit or loss.

For all of the above reasons we believe the IFRIC should take this matter onto its agenda with a view to a full interpretation. We consider that there will be diversity of application in practice if this issue is not fully addressed. We believe the IFRIC needs to address simultaneously the question of the scope of the amendment to the definition of a derivative and the interaction with IFRS 4 and what is a non-financial item in order to avoid this diversity in practice. This issue has far-reaching consequences for many types of arrangements. If the IFRIC decides not to put the matter on its agenda with a view to a full interpretation we believe that, at a minimum, the IFRIC should refer the issue of the amendment that was made to the definition of a derivative to the Board so IFRIC can understand the Board's intention when it amended IAS 39 when it finalised IFRS 4.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907.

Sincerely,



Ken Wild
Global IFRS Leader

cc: Allan Cook, IFRIC

Mr Robert P. Garnett
IFRIC
30 Cannon Street
London EC4M 6XH

United Kingdom

Paris, le 25 September 2006

Tentative Agenda Decisions – IAS 39 Financial Instruments: Recognition and Measurement: Definition of a derivative – Indexation on own EBITDA or own revenue

Dear Sir,

We have examined the IFRIC rejection for a possible agenda item by which the IFRIC was asked to provide guidance on the definition of a derivative about two specific matters:

- Under paragraph 9 of IAS 39, should the exclusion from the definition of a derivative of contracts, whose value changes in response to changes in a non-financial variable that is specific to a party, be limited to insurance contracts?
- Does a contract that is indexed on an entity's own revenue or own earnings before interest, tax, depreciation and amortisation (EBITDA) meet the definition of a derivative under IAS 39 or does it meet the exclusion in paragraph 9?

We agree with the IFRIC that the exclusion in paragraph 9 of IAS 39 for non-financial variables that are specific to a party to the contract is not restricted to insurance contracts, nothing in the core of the Standard indicating such a restriction.

We also agree that the Standard is unclear to decide whether a contract that is indexed to an entity's own revenue or own EBITDA meets the definition of a derivative under IAS 39, but we disagree with the IFRIC decision not to take the issue onto its agenda.

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Some constituents consider that paragraphs in application guidance (AG 33f) and implementation guidance (IGB8) of IAS 39 give guidance on this issue and conclude that contracts that are indexed to an entity's own revenue or EBITDA meet the definition of an

embedded derivative. Our opinion is that these paragraphs seem contradictory to the definition of a derivative given in paragraph 9 of the Standard because they have not been revised when the definition of a derivative was amended, pursuant to the adoption of IFRS 4.

Furthermore, in our view, if such an indexation were to be considered as a derivative, the fair value might not be reliably measurable as there is no quoted price and no reliable valuation technique for such an indexation.

According to the definition in paragraph 9, we believe it would not be consistent with the Standard to consider an indexation on its own revenue or its own EBITDA as a derivative. However, we are of the opinion that the IFRIC should take this issue onto its agenda as the limit between a financial and a non-financial variable needs to be clarified to avoid great diversity in practice.

We hope you will consider our view on this important topic and stay at your disposal to further discuss it. Would you have any request regarding the above comments, please do not hesitate to contact Michel Barbet-Massin (+33 1 49 97 62 27).

Yours faithfully

Michel Barbet-Massin
Head of Accounting Principles Department