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International
Accounting Standards
Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**21 February 2007, London**
Project:	**IAS 39 *Financial Instruments: Recognition and Measurement***
Subject:	**Definition of a derivative – Indexation on an entity's own revenue or EBITDA (Agenda paper 5)**

BACKGROUND INFORMATION

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

2. The original submission to the IFRIC uses a debt contract with interest and principal payments indexed to its revenue or EBITDA as an illustration. The amounts of interest and principal payments will change in response to changes in the issuer's revenue or EBITDA.

3. IAS 39 paragraph 9 states: 'A derivative is <u>a financial instrument or other contract within the scope of this Standard</u> with all of the following characteristics: (a) its value changes in response to the change in 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; …'.

SUMMARY OF THE IFRIC DISCUSSIONS[1]

4. To address the issue set out in paragraph 1 of this paper, the IFRIC identified the following two questions:
   (a) whether changes in an entity's own revenue or EBITDA should be considered as financial or non-financial variables; and
   (b) whether the exclusion from the definition of a derivative in IAS 39 of a contract linked to non-financial variables that are specific to a party to the contract is restricted to contracts accounted for under IFRS 4.

5. The IFRIC noted that existing IFRSs do not define what financial and non-financial variables are. Nor do they specify whether changes in an entity's revenue or EBITDA are financial or non-financial variables.

6. The IFRIC acknowledged that the definitions of financial and non-financial variables are crucial in determining whether a financial instrument that contains the characteristics of 'derivative' should be accounted for as a derivative in accordance with IAS 39. However, given the issues involved, the IFRIC believed that it is highly unlikely to reach consensus on a timely basis on an interpretative issue regarding what financial and non-financial variables are.

7. Some IFRIC members noted that the amendment to the definition of a derivative in IAS 39 was made when IFRS 4 was amended. Therefore, they argued that the amendment was intended to scope out from IAS 39 contracts that would be accounted for under IFRS 4. However, there are no explicit statements in IAS 39 that support that view.

8. The IFRIC noted that taking no action on this issue would allow continued significant diversity in practice. Therefore, at its meeting in January 2007, the IFRIC directed the staff to refer the issue to the Board. The IFRIC recommended that the Board should amend IAS 39 through the Board's Annual Improvements Process to restrict the exclusion from the definition of a derivative in IAS 39 to contracts accounted for under IFRS 4.

[1] The IFRIC's decision on this issue has been set out in Appendix 1 to this paper.

SCOPE OF THIS PAPER

Not to discuss what financial and non-financial variables are

9. This paper does not address the first question set out in paragraph 4(a) of this paper – that is, what financial and non-financial variables are.

10. The distinction between financial and non-financial variables is important in determining (a) whether an item is in the scope of IAS 39 or IFRS 4[2], and (b) whether an item in the scope of IAS 39 (a standalone contract or embedded in a contract) should be accounted for as a derivative.

11. [Paragraph omitted from observer note].

To discuss items in the scope of IAS 39

12. This paper focuses on items that are clearly within the scope of IAS 39 (not in the scope of IFRS 4). This paper addresses whether those items (a standalone contract or embedded in a contract) should be accounted for as derivatives.

DIVERSITY IN PRACTICE

13. The original submission to the IFRIC uses a debt contract with interest and principal payments indexed to the issuer's revenue or EBITDA as an illustration.

14. Since the introduction of the amendment to a derivative in IAS 39 was made at the time when IFRS 4 was issued, some argue that the amendment to the definition of a derivative in IAS 39 was only intended to scope out from IAS 39

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[2] IFRS 4 defines insurance contracts as contracts under which one party (the insurer) accepts significant insurance risks from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder (see IFRS 4 Appendix A).

B14 of IFRS 4 states: 'Some contracts require a payment if a specified uncertain event occurs, but do not require an adverse effect on the policyholder as a precondition for payment. Such a contract is not an insurance contract even if the holder uses the contract to mitigate an underlying risk exposure. For example, if the holder uses a derivative to hedge an underlying non-financial variable that is correlated with cash flows from an asset of the entity, the derivative is not an insurance contract because payment is not conditional on whether the holder is adversely affected by a reduction in cash flows from the asset.

contracts that should instead be accounted for under IFRS 4. They note the following from the June 2003 IASB Update:

"The Board agreed to replace the words 'similar variable' with the phrase 'other variable, provided that in the case of a non-financial variable that the variable is not specific to a party to the contract'. This phrase distinguishes two types of non-financial variable:

- some non-financial variables are <u>specific</u> to a party to the contract, such as the occurrence or non-occurrence of a fire that damages or destroys an asset of that party. The risk of changes in these variables is an <u>insurance risk</u>.

- other non-financial variables are <u>not specific</u> to a party to the contract, such as an index of earthquake losses in particular region or an index of temperatures. The risk of changes in these variables is a <u>financial risk</u>.'

15. There is no doubt that the debt contract set out in paragraph 2 of this paper should be accounted for in accordance with IAS 39 (not IFRS 4). However, because current IFRSs do not specify whether changes in an entity's revenue or EBITDA are financial or non-financial variables, the following two possible different accounting treatments arise (assuming that such a debt contract is accounted for using the amortised cost basis):

    - Method 1 – Assuming that the exclusion from the definition of a derivative in IAS 39 <u>is restricted</u> to contracts that are accounted for under IFRS 4. The embedded derivative is accounted for separately from the host debt contract provided that the embedded derivative is not closely related to the host contract; and

    - Method 2 – Assuming that the exclusion from the definition of a derivative in IAS 39 <u>is not restricted</u> to contracts that are accounted for IFRS 4 and the debt contract in its entirely is accounted for on an amortised cost basis. Method 2 assumes that changes in an entity's own revenue or EBITDA should be considered as non-financial variables.

16. Under Method 1, the embedded derivative is measured at fair value with changes in fair value recognised in profit or loss and the host contract is accounted for on

an amortised cost basis with the effective interest rate determined based on the normal market interest rate estimated at the time when the contract is entered into.

17. Under Method 2, the entire debt contract will be accounted for in accordance with AG8 of IAS 39.

18. AG 8 of IAS 39 requires that an entity should revise its estimates of interest cash flows when there are changes in expected EBITDA or revenue. The entity should recalculate the carrying amount of the debt by computing the present value of the revised cash flows at the original effective interest rate with the adjustment to the carrying amount of the debt being recognised in profit or loss.

19. [Paragraph omitted from observer note].

RECOMMENDED AMENDMENTS TO IAS 39

20. The IFRIC recommended that the Board should amend IAS 39 through the Board's Annual Improvements Process to restrict the exclusion from the definition of a derivative in IAS 39 to contracts accounted for under IFRS 4. Proposed amendments to IAS 39 are set out in Appendix 2 to this paper.

21. The list of variables in the definition of financial risk in IFRS 4 is the same as that in the definition of derivative in IAS 39. However, the staff does not recommend any amendments to the definition of financial risk in IFRS 4. As mentioned earlier, the purpose of this paper is not to define the line between the scopes of IFRS 4 and IAS 39.

QUESTIONS TO THE BOARD

22. Does the Board agree that the exclusion from the definition of a derivative in IAS 39 should be restricted to contracts that are accounted for in accordance with IFRS 4?

23. Does the Board wish to pursue the proposed amendments set out in Appendix 2 to this paper? If not, how would the Board clarify the standards? (Any drafting comments on the proposed amendments and consequential amendments are welcomed from the Board after the meeting.)

POSSIBLE PROCESS FOR THE PROPOSED AMENDMENTS TO IAS 39

24. If the Board wishes to amend IAS 39 (as set out in Appendix 2 to this paper), it should consider how to develop the proposed amendments. The Board could develop the proposed amendments through a standalone project or the Board's Annual Improvements Process.

25. The Board's Annual Improvements Process aims to address non-urgent, minor amendments to IFRSs. Such amendments will focus on areas of inconsistency in standards or where clarification of wording is required. The first omnibus exposure draft of the Annual Improvements Process is expected to be issued on 1 October 2007 with amendments effective 1 January 2009.

26. The above proposed amendments are 'minor' in terms of the number of words that should be amended.

27. The IFRIC recommended that the Board could amend the relevant IFRSs through the Board's Annual Improvements Process.

QUESTION TO THE BOARD

28. Does the Board agree that the proposed amendments set out in Appendix 2 to this paper should be made through the Board's Annual Improvements Process?

APPENDIX 1 – IFRIC AGENDA DECISION IN JANUARY 2007

In July 2006, the IFRIC published a tentative agenda decision that explained why it had decided not to issue guidance on whether a contract that is indexed to an entity's own revenue or own earnings before interest, tax, depreciation and amortisation (EDITDA) is (or might contain) a derivative.

The tentative agenda decision addressed two issues:

- Whether the exclusion from the definition of a derivative of contracts linked to non-financial variables that are specific to a party to the contract only applies to insurance contracts; and
- Whether EBITDA or revenue is a financial or non-financial variable.

The tentative agenda decision concluded that:

- the exclusion from the definition of a derivative of contracts linked to non-financial variables that are specific to a party to the contract is not restricted to insurance contracts, based on the current drafting of the standard; and
- although IAS 39 is unclear as to whether revenue or EBITDA are financial or non-financial variables, the IFRIC would not take this issue onto its agenda as it is unlikely to reach a consensus on this question on a timely basis.

At the January 2007 meeting, the IFRIC decided to withdraw the tentative agenda decision.

Having reconsidered the issue, the IFRIC noted that taking no action would allow continued significant diversity in practice regarding how financial and non-financial variables were determined.

Consequently, the IFRIC directed the staff to refer the issue to the Board. The IFRIC recommended that the Board amend IAS 39 (possibly as part of the annual improvements process) to limit to insurance contracts the exclusion from the definition of a derivative of contracts linked to non-financial variables that are specific to a party to the contract.

APPENDIX 2 PROPOSED AMENDMENTS TO IAS 39

[Appendix 2 omitted from observer note].