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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **January 2007, London**

Project: **IAS 39 *Financial instruments: Recognition and measurement* – definition of a derivative – indexation on own EBITDA or own revenue**
(Agenda Paper 7)

Introduction

1. The IFRIC has been 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.

2. The IFRIC discussed this issue in July and November of 2006. The purpose of this paper is to summarise the discussions that have been held so far and to ask the IFRIC how it would like to take this issue forward.

Description of issue

3. The IFRIC has been 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.

4. In order to be able to address this issue, the IFRIC must interpret the definition of a derivative in paragraph 9 of IAS 39:

A derivative is a financial instrument or other contract within the scope of this Standard (see paragraphs 2–7) with all three 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, <u>provided in the case of a non-financial variable that the variable is not specific to a party to the contract</u> (sometimes called the 'underlying');*
b) *it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and*
c) *It is settled at a future date.* [Emphasis added]

5. In particular, two questions need to be addressed:

- Does the exclusion from the definition of a derivative of contracts that are linked to non-financial variables that are specific to a party to the contract only apply to insurance contracts; and
- Does EBITDA or revenue represent a financial or non-financial variable?

6. The Staff's analysis of these questions can be found in agenda paper 10(vi) from the July 2006 meeting (reproduced as appendix 1 to this paper).

Summary of IFRIC discussions

7. At its July 2006 meeting the IFRIC decided that:

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

8. Consequently, the IFRIC decided to issue draft rejection wording (reproduced as appendix 2 to this paper).

9. The IFRIC received two letters objecting to the IFRIC's decision not to take this issue on to its agenda.

10. The first letter disagreed with the IFRIC's conclusion that the exclusion from the definition of a derivative of contracts that are linked to non-financial variables that are specific to a party to the contract does not only apply to insurance contracts. The second letter agreed with the IFRIC's conclusion regarding the scope of the exclusion from the definition of a derivative but disagreed with the IFRIC's decision not to take this issue on to the agenda. The second letter argued that unless the IFRIC provided guidance on what is a financial or non-financial variable, significant divergence in practice would emerge.

11. The IFRIC discussed both letters at its November 2006 meeting. One IFRIC member suggested that work currently being carried out at the FASB might help the IFRIC arrive at a more satisfactory solution to this issue.

12. It was therefore agreed that the IASB staff would discuss this issue with the FASB staff.

Update on discussions with FASB

13. Unfortunately, the research that the FASB staff are carrying out does not address either of these issues.

The way forward

14. The IFRIC must now consider how to take this issue forward.

15. If the IFRIC still believes that the exclusion from the definition of a derivative of contracts that are linked to non-financial variables that are specific to a party to the contract is not restricted to insurance contracts, it has two options available:

- The IFRIC could decide to finalise the original rejection wording; or
- The IFRIC could decide to develop an Interpretation. Any Interpretation would have to address whether revenue or EBITDA are financial or non-financial variables. As discussed in the July paper, the staff believe that this is not a straightforward issue. Indeed the IFRIC at its July meeting

concluded it was unlikely to reach a consensus on this issue on a timely basis.

16. Before deciding whether to take this issue on to its agenda, the IFRIC should also consider the other agenda criteria. That is, does the issue have practical and widespread relevance and/or involve significant divergent interpretations (either emerging or already existing in practice). The IFRIC must also consider whether the issue is related to a Board project that is expected to be completed in the near future.

17. As set out in the original agenda paper, the staff believe that the exclusion from the definition of derivatives of non-financial variables that are specific to a party to the contract is not restricted to insurance contracts and that this is clear from the standard. However, if the IFRIC now believes that the exclusion from the definition of a derivative of contracts that are linked to non-financial variables that are specific to a party to the contract is (or was intended to be) restricted to insurance contracts, the IFRIC could ask the Board to clarify this by amending the standard (possibly as part of the annual improvements process).

How would the IFRIC like to address this issue? The options available to the IFRIC are:

- **Option 1 – Finalise the original rejection wording;**
- **Option 2 – Decide to take the issue on to the agenda and provide guidance on whether EBITDA and revenue are financial or non-financial variables;**
- **Option 3 – Do not take the issue onto the IFRIC agenda but ask the Board to clarify the definition of derivative contracts by amending the standard (possibly as part of the annual improvements process).**

APPENDIX 1 – Agenda paper 10(vi) from the July 2006 meeting

IAS 39 *Financial instruments: Recognition and measurement* – definition of a derivative – indexation on own EBITDA and own revenue

Introduction

1. The IFRIC has been asked to provide guidance on whether a contract which 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.

2. [*Paragraph omitted from observer notes*]

Summary of issue

3. To illustrate the issue, consider the following example:

   Example
   Entity A has issued a perpetual debt instrument which is classified as a financial liability. Annual interest payments comprise a fixed coupon plus a variable coupon indexed to changes in the entity's revenue.
   Entity A has issued a similar instrument whose variable element is indexed to its own EBITDA.

4. IFRIC members are asked to determine whether the element of the contract which indexes payments to the entity's own EBITDA or revenue meets the definition of a derivative.
5. If it is concluded that contracts of this type contain derivatives, the resulting embedded derivative may be required to be separated from the host debt contract and accounted for as a derivative.

Staff recommendation

6. In order to be able to address the issue raised, the definition of a derivative in paragraph 9 of IAS 39 must be interpreted[1]. In particular, two questions need to be addressed:

   - Does the exclusion from the definition of a derivative of contracts that are linked to non-financial variables that are specific to a party to the contract only apply to insurance contracts; and
   - Does EBITDA or revenue represent a financial or non-financial variable?

Does the exclusion in paragraph 9(a) only apply to non-financial variables within insurance contracts?

7. It is the staff's view that the exclusion from the definition of derivatives of non-financial variables that are specific to a party to the contract is not restricted to insurance contracts and that this is clear from the standard. The staff therefore recommend that the IFRIC should not take this question on to its agenda. Draft wording for an agenda decision is provided in appendix A.

Does the IFRIC agree with the staff recommendation that the IFRIC should not take this question on to its agenda?

Does EBITDA or revenue represent a financial or non-financial variable?

8. Having reviewed the applicable literature, the staff have concluded that it is unclear what is meant by the term "non-financial variable" in paragraph 9 of IAS 39. The staff believe that it is therefore not possible to conclude whether or not a contract that is indexed to an entity's own EBITDA or revenue meets the definition of a derivative.

9. The staff believe there are three options available to the IFRIC:

   (a) The IFRIC could decline to take the item on to its agenda;

   (b) The IFRIC could add this issue to its agenda for interpretation;

[1] See paragraph 16 for the definition of a derivative under IAS 39.

(c) The IFRIC could refer the matter to the Board with a view to amending IAS 39.

10. The staff note that any interpretation (option b) would need to address the definition of a non-financial variable. Given the issues involved, the staff do not believe it would be possible to arrive at a consensus on this issue within a reasonable timeframe.

11. [*Paragraph omitted from observer notes*]

12. Consequently, unless the IFRIC believe that this issue has widespread practical relevance and there is significant diversity in practice, the staff recommend that the IFRIC decline to take this issue on to its agenda. Wording for a draft agenda decision is included in appendix A [*Appendix omitted from observer notes*].

Does the IFRIC agree with the staff recommendation that the IFRIC should not take this question on to its agenda?

Analysis

13. An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative [IAS 39.10].

14. IAS 39 paragraph 11 requires embedded derivatives to be separated from the host contract and accounted for as derivatives if and only if:
    a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
    b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
    c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss.

15. This paper assumes that conditions (a) and (c) of paragraph 11 are met for the instrument described above and analyses whether condition (b) is fulfilled. That is, does the element of the contract which indexes payments to the entity's own EBITDA or revenue meet the definition of a derivative?

Definition of a derivative

16. Derivatives are defined in IAS 39 paragraph 9 as follows:

A derivative is a financial instrument or other contract within the scope of this Standard (see paragraphs 2–7) with all three of the following characteristics:

- *d) 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 (sometimes called the 'underlying');*
- *e) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and*
- *f) It is settled at a future date.* [Emphasis added]

17. In the instrument described above it is clear that the element of the contract that links interest payments to EBITDA or revenue requires little or no initial net investment and is settled at a future date. Therefore, the definition of a derivative will be met if the requirements in sub-paragraph (a) are met.

18. There are therefore two key questions:

- does sub-paragraph (a) apply to contracts of this type; and
- if sub-paragraph (a) does apply, does EBITDA or revenue represent a financial or non-financial variable?[2]

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[2] It is clear that own EBITDA and own revenue are specific to a party to the contract therefore this condition of sub-paragraph (a) is not considered further.

Does sub-paragraph (a) apply to contracts of this type?

19. IAS 39.9 was modified following the introduction of IFRS 4 to include the concept of *"a non-financial variable that … is not specific to a party to the contract."* This modification was required to help distinguish insurance contracts from financial instruments. Indeed, the examples provided in AG12A of contracts that do not give rise to an embedded derivative are all clearly of an insurance nature.

20. AG 12A states the following:
    The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.

21. Some therefore argue that the exclusion in paragraph 9 for non-financial variables that are specific to a party to the contract only applies to insurance contracts. The indexation of payments on a debt instrument to EBITDA or revenue cannot be viewed as an insurance contract as it is not "*A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policy holder if a specified uncertain future event (the insured event) adversely affects the policy holder."* [IFRS 4 – Insurance contracts, Appendix A]

22. Some support for the view that this exception should only be applied in the context of insurance contracts can be found in the application guidance to IAS 39. In particular, AG 33(f)(ii) (see appendix) indicates that contingent rentals

in a host lease contract that are based on sales meet the definition of an embedded derivative (even though the derivative would normally be considered to be closely related).

23. In addition, the implementation guidance to IAS 39 (IG A.2 (see appendix)) states that a put option held by an entity that enables that entity to put its own office building (a non-financial asset specific to a party to the contract) to an investor meets the definition of a derivative.

24. Supporters of the view that the exclusion applies more widely than just insurance contracts argue that these paragraphs directly contradict the definition in paragraph 9 and should have been revised when the definition of a derivative was amended.

25. The staff note that there is no explicit statement within the standard that this exception to the definition of a derivative applies only to non-financial variables that are the subject of insurance contracts. AG33 and IG A2 imply that there may be such a restriction. However, it is the staff's view that it is not possible to conclude from reading the standard as currently written that the exception applies only to non-financial variables that are the subject of insurance contracts.

26. The staff therefore believe that there are three alternatives available to the IFRIC:
    g) If the IFRIC believes that the current wording of IAS 39 does not properly reflect the intention of the Board when amending IAS 39, (that is, the IFRIC believes that the Board intended to restrict the exclusion from the definition of derivatives to non-financial variables that are subject to insurance contracts) the IFRIC should consider referring the matter to the Board with a view to amending IAS 39;
    h) If the IFRIC believes that IAS 39 properly reflects the Board's intentions and that AG 33(f) and IG A2 conflict with the requirements of IAS 39, the IFRIC could request that the Board amend this guidance; or

i) If the IFRIC believes that IAS 39 properly reflects the Board's intentions, the IFRIC could issue an agenda decision, stating that it is clear 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.

27. The staff note that the Board intends to fundamentally revise IAS 39 in the medium term and has, in the past, expressed a reluctance to make minor amendments to the current version of IAS 39. The staff therefore recommend that the IFRIC adopt alternative c). Draft wording for an agenda decision is provided in the appendix [*Appendix omitted from observer notes*]

Does EBITDA or revenue represent a financial or non-financial variable?

28. If it is concluded that the exclusion in sub-paragraph (a) is not restricted to non-financial variables that are embedded in insurance contracts, it is necessary to consider whether EBITDA or revenue represent a financial or non-financial variable.

29. IAS 39 does not define what is meant by financial or non-financial variables. The only guidance provided in IAS 39 on the subject of non-financial variables is on when a non-financial variable is specific to a party to the contract. There is, of course, no doubt that an entity's own EBITDA or revenue is specific to a party to the contract. However, this guidance may help clarify what is meant by a non-financial variable.

30. As cited above, paragraph AG12A of IAS 39 states:
"…A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car."

31. This paragraph implies that a non-financial variable that is specific to the parties to the contract has the following characteristics:

- The underlying is not a financial instrument; and
- The fair value of the underlying changes in response to both market prices for the item and the specific condition of the non-financial instrument held.

32. Where an underlying is readily identifiable, these principles are easy to apply as financial assets and liabilities are clearly defined. For example, a contract that is indexed to the price of cocoa has a non-financial asset as its underlying but is clearly not specific to the parties to the contract and would therefore meet the definition of a derivative. However, it is difficult to apply these principles to EBITDA and revenue as there is no clear underlying item. EBITDA and revenue do not vary solely in response to changes in the fair value of non-financial assets or non-financial liabilities.

33. EBITDA and revenue are measures of the performance of an entity. The fair value of EBITDA and revenue are driven by a number of different factors many of which are clearly non-financial in nature, for example the general business risks faced by the entity. In addition, many of the drivers of EBITDA and revenue will be specific to that business, for example, the location of the business, the nature of its goods or services, management actions. Supporters of the view that contracts indexed to EBITDA and revenue are not derivatives argue that these factors taken together are sufficient to conclude that EBITDA and revenue are non-financial variables that are specific to the parties to the contract.

34. However, some of the guidance in IAS 39 appears to contradict the view that revenue is a non-financial variable. AG33f(ii) (see appendix) indicates that contingent rentals in a host lease contract that are based on sales meet the definition of an embedded derivative (even though the derivative would normally be considered to be closely related). However, as noted above, it can be argued that AG33f(ii) appears to contradict the definition of a derivative in IAS 39 so it may not be possible to draw conclusions from this guidance.

35. IG B8 (see appendix) implies that contracts whose payments are linked to sales volumes include embedded derivatives.

36. Those who support the view that revenue represents a non-financial variable argue that IG B8 should have been revised when the definition of a derivative was amended and that they were overlooked in much the same way as AG 33 and IG A.2. However, without a definition of - or guidance on - what is meant by a non-financial variable, the staff believe it is difficult to state whether this view is correct.

37. It is also argued that IG B8 is unclear as it includes two underlying variables one which is clearly financial (the foreign exchange rate) and one which is not (the volume of sales). The existence of the financial variable, it is argued is sufficient to conclude that the contract contains an embedded derivative.

38. Supporters of the view that revenue represents a non-financial variable also refer to AG 2 which states: *"This standard does not change the requirements relating to …royalty agreements based on the volume of sales or service revenues that are accounted for under IAS 18 Revenue."* They argue that if revenue is a financial variable, then royalty agreements based on the volumes of sales or service revenues would clearly contain embedded derivatives as defined in IAS 39 and the accounting for these contracts would be very different to that required in IAS 18.

39. However, the staff believe that paragraph AG2 represents a scope exclusion for royalty agreements that are based on the volumes of sales or service revenues. Therefore, although it is curious that this apparent scope exemption is included in the application guidance rather than in the standard, it can not be used to draw conclusions about whether revenue is a financial or non-financial variable.

40. As can be seen from the discussion above, the guidance in IAS 39 on what constitutes a non-financial variable is confusing and could support different

interpretations. The staff have therefore considered whether it would be possible to derive a definition of non-financial variables from other guidance.

41. A non-financial variable is presumably anything that is not a financial variable. A reasonable definition of a financial variable might be an item whose value changes in response to financial risks. As discussed in paragraph 27 above, it can be argued that EBITDA and revenue are driven predominately by non-financial risks[3].

42. Financial risks are defined in IFRS 4 as follows: "*The risk of a possible future change 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."* Unfortunately, this brings us back to the need to define financial variables.

43. It is interesting to note that US GAAP explicitly deals with the issue of contracts that are linked to revenue. Paragraph 10(e) of FAS 133 states the following:

"<u>Certain contracts that are not traded on an exchange</u>. Contracts that are not exchange-traded are not subject to the requirements of this Statement if the underlying on which the settlement is based is one of the following:

(1) A climatic or geological variable or other physical variable [<u>C1</u>]

(2) The price or value of (a) a non-financial asset of one of the parties to the contract provided that the asset is not readily convertible to cash or (b) a non-financial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is readily convertible to cash [<u>B26</u>, <u>C5</u>]

(3) Specified volumes of sales or service revenues of one of the parties to the contract."

44. However, this does not really help interpret the requirements of IAS 39 as it does not include the more general concept of a non-financial variable.

[3] Except in the case of a financial institution.

Staff recommendation

45. Having reviewed the applicable literature, the staff have concluded that it is unclear what is meant by the term “non-financial variable” in paragraph 9 of IAS 39. The staff believe that it is therefore not possible to conclude whether or not a contract that is indexed to an entity’s own EBITDA or revenue meets the definition of a derivative.

46. The staff believe there are three options available to the IFRIC:

(d) The IFRIC could decline to take the item on to its agenda;

(e) The IFRIC could add this issue to its agenda for interpretation;

(f) The IFRIC could refer the matter to the Board with a view to amending IAS 39.

47. The staff note that any interpretation (option b) would need to address the definition of a non-financial variable. Given the issues involved, the staff do not believe it would be possible to arrive at a consensus on this issue within a reasonable timeframe.

48. [*Paragraph omitted from observer notes*]

49. Consequently, unless the IFRIC believe that this issue has widespread practical relevance and there is significant diversity in practice, the staff recommend that the IFRIC decline to take this issue on to its agenda.

APPENDIX 2 – Tentative agenda decision published in IFRIC Update

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

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.