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International Accounting Standards Board

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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: **May 2007, London**

Project: **Gaming Transactions (Agenda Paper 11(i))**

INTRODUCTION

1. The IFRIC received a request for guidance as to how a gaming institution should account for bets or wagers received. The question focussed on whether such transactions give rise to revenue or whether unsettled wagers are financial instruments which should be accounted for using IAS 39.

2. Different accounting treatments were identified including:

   - that the gaming institution should account for the wager as revenue upon receipt of the stake. Any payout should be accounted for as an expense;
   - that the gaming institution should account for the wager as revenue when the wager is settled; or
   - that the gaming institution should account for the wager as a derivative instrument under IAS 39. The derivative instrument should be recognised at fair value with gains or losses recognised in the income statement.

3. This paper sets out the staff's analysis of the issue and whether it should be taken onto the IFRIC's agenda.

SCOPE AND BACKGROUND

4. The staff notes that a wide range of different forms of gaming exist. These include:

- regular sporting and other bets in which a bookmaker offers ‘odds’ to customers and customers enter into a wager on the outcome of some future uncertain event;
- casino bets in which the casino takes a position against that of the customer and offers ‘odds’ to them dependent on the outcome of some future uncertain event;
- casino betting with other participants such as poker in which customers bet with each other and the casino takes a percentage of the customers’ winnings;
- pools in which the total of all amounts bet are pooled and then allocated to the winner with the gaming institution taking a percentage of the pool for providing administrative services;
- lotteries which operate in a similar manner to pools;
- sporting spread betting; and
- other spread betting – such as against financial markets.

Categorisation of wagers

5. The staff considers that the above cases can be broadly split into two main categories;

- transactions in which the gaming institution takes a position against that of the customer such that the gaming institution’s net gain on that transaction is determined by some uncertain future event; and
- transactions in which the gaming institution administers a scheme amongst customers and receives a commission based upon the amount wagered. In these situations, the gaming institution’s net gain on any wager can be determined at the point at which the wager is placed irrespective of the outcome of the future event on which the customer is betting.

6. The staff has considered the accounting for these two different types of transaction separately below.

7. The staff noted that transactions in which the gaming institution takes a position against that of the customer could be subdivided further. For example, the following distinctions could be drawn:

   - Wagers could be divided between those for which the potential outflow to the gaming institution is limited (for example a fixed odds wager) and those for which the outflow may be unlimited (for example a spread bet)[1].
   - A distinction could be drawn between wagers which are settled very quickly (for example slot machines) and those which may remain outstanding over a period of time.
   - A distinction could be drawn between bets on financial variables (for example a spread bet on a financial market) and bets on non-financial variables (for example a sporting spread bet).

8. The staff considers that there is no reason why any of the above distinctions should result in differing accounting treatments. The staff has not therefore considered these further subdivisions in this paper.

Laying off of wagers

9. Many gaming entities will lay off bets that they receive. The staff considers that, whether an entity hedges or lays off the risks associated with an instrument should not affect the accounting treatment for that instrument unless it results in the derecognition (or partial derecognition) of the instrument or hedge accounting is available. The staff also notes that, when an outsider is victorious in a sporting event, it is often described as a 'bad result' for the gaming institutions. If that is the case, the gaming institutions can not have laid off all of their risks associated with the wager.

10. In the light of the above, the staff does not believe that all risks are routinely laid off by gaming institutions. Even if they are, this fact should not influence the accounting for an unsettled wager (unless it results in the derecognition of the wager or hedge accounting is available). Since derecognition is unlikely to

[1] The staff notes that, even in the case of spread bets, winnings and losses are often limited by floors and ceilings.

be achieved in situations where a gaming institution has a contingent obligation to pay, the staff has not considered the laying off of wagers further.

DIFFERING VIEWS

11. The request submitted to the IFRIC included differing views as to how gaming receipts should be accounted for. These views are summarised below.

View 1 – IAS 18 Gross Revenue recognition with immediate recognition

12. IAS 18.7 states that **'Revenue** is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.'

13. Supporters of view 1 argue that the receipt of a wager is an inflow which increases the equity of an entity and does not relate to a contribution from an equity participant. The receipt of the wager therefore meets the definition of revenue.

14. Supporters of this view also note that:

    - Once received, the amount of the wager is known and can be measured reliably.
    - The service provided by the gaming institution is the taking of wagers by one party and matching those with opposing wagers placed by other parties. Once a wager has been placed, the gaming institution has completed its services to its customer.
    - The cost of placing the bet is known and can be reliably measured. In addition, wagers are normally laid off by gaming institutions so the cost of settlement can be reliably measured.

15. Supporters of view 1 therefore believe that, not only are wagers revenue, but as soon as the wagers are placed they may be recognised as revenue immediately.

16. Supporters of view 1 may characterise the transaction as one in which the customer uses a gaming institution as a go-between in order to locate other customers willing to provide opposing wagers. The gaming institution provides the service of matching the gamer with other parties willing to oppose their

position. Since the gaming institution lays the bet off immediately, it has no further exposure beyond that point.

View 2 – IAS 18 Net Revenue recognition with immediate recognition

17. Supporters of view 2 hold the same view as supporters of view 1 except that they believe that a gaming institution should recognise revenue as the net of the gaming receipt and the expected payout.

18. Supporters of this view believe that the service that a gaming entity undertakes is to match gaming parties so that they may enter transactions with each other. It therefore acts as agent for the gaming parties. The fee for its services is reflected in the odds charged. The gaming institution should recognise its commission as revenue being the difference between the amount received and the expected pay out.

View 3 – deferred recognition of revenue

19. Supporters of view 3 believe that gaming receipts should be accounted for as revenue. However, they do not believe that the associated revenue should be recognised before the wager is settled.

20. Supporters of this view note that IAS 18.20 requires that the amount of revenue and the costs incurred must be measured reliably before an entity may recognise revenue.

21. Supporters of this view note that, before a wager is settled, it is unclear whether there will be a payout, no payout, or a return of stake (for example if the event is cancelled). Therefore, before the wager is settled, neither the costs nor the revenue can be measured reliably and as such revenue may not be recognised until the outcome of the wager is settled.

View 4 – IAS 39 derivatives

22. Supporters of view 4 believe that bets are derivative instruments that should be accounted for in accordance with IAS 39. Supporters of this view believe that the bets should be recognised in an entity's balance sheet at fair value with gains or losses taken to the income statement.

STAFF ANALYSIS

23. In deciding on how to account for wagers, it is first necessary to conclude whether they are financial instruments which fall within the scope of IAS 39. If the IFRIC concludes that they are then it will be necessary to determine how they should be classified and accounted for.

Is a wager in the scope of IAS 39?

Is a wager a financial instrument?

24. IAS 32 defines a financial instrument as: "any <u>contract</u> that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity."

Is a wager a contract?

25. In some jurisdictions, a wager does not give rise to a contract that is enforceable under local contract law. IAS 32.18 defines a contract as "an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing."

26. A gaming transaction constitutes an agreement between two or more parties and has clear economic consequences for both. Furthermore, in most countries, gambling is heavily regulated and only parties acting within a regulated framework are licensed to operate gaming institutions. Such entities can not realistically fail to pay out on a good wager.

27. In most situations, a gaming institution entering into a wager with a customer will therefore have little or no discretion as to whether it pays out on the bet. The staff therefore considers that a wager should be treated as a contract for the purposes of IAS 32.

Does a gaming contract give rise to a financial asset and a financial liability?

28. To meet the definition of a financial instrument, a wager must give rise to a financial asset of one entity and a financial liability or equity instrument of another.

29. IAS 32.11 states that financial assets include cash, a contractual right to receive cash from another entity, and a contractual right to exchange financial assets or liabilities with another entity under conditions that are potentially favourable to the entity.

30. A customer that has placed a wager will have a contractual right to receive cash from a gaming institution that is contingent on the occurrence of some future uncertain event. IAS 32.AG8 states that ‘‘the ability to exercise a contractual right …may be contingent on the occurrence of a future event.’ AG8 also states that a contingent right meets the definition of a financial asset.

31. An unsettled wager therefore gives rise to a financial asset for the customer.

32. IAS 32.11 states that a contractual obligation to deliver cash or another financial asset to another entity is a financial liability.

33. A gaming institution which has accepted a wager will have a contractual obligation to deliver cash which is contingent on the occurrence of a future event. In the same way that a contractual right to receive cash that is contingent on the occurrence of a future event meets the definition of a financial asset, IAS 32.AG8 states that a contractual obligation to deliver cash that is contingent on the occurrence of a future event meets the definition of a financial liability

34. A wager therefore gives rise to a financial liability for the gaming institution.

35. Since a wager gives rise to a financial asset in one entity and a financial liability in another, it meets the definition of a financial instrument.

Are wagers within the scope of IAS 39?

36. The scope of IAS 39 includes all financial instruments except certain instruments which are set out in IAS 39.4 (a) – (f). The staff considers that, with the possible exception of IAS 39.4(d) relating to insurance contracts, it is clear that a wager will not qualify for any of the exceptions in IAS 39.4 (a) – (f). Whether a wager may meet the definition of an insurance contract is discussed further below.

37. IFRS 4 defines insurance contracts as those ‘under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by

agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.'

38. Insurance risk is defined as 'risk, other than financial risk, transferred from the holder of a contract to the issuer.'

39. The staff considers that a wager is unlikely to meet the definition of an insurance contract for a number of reasons:

    - A gaming transaction is typically entered into to create a position or risk rather than to transfer existing risk either of the customer or the gaming institution. 'Gaming risk' is therefore unlikely to meet the definition of insurance risk.
    - A gaming transaction is not designed to compensate either party for a loss. Instead, it is designed to reward a winning party.
    - A wager is settled on an uncertain future event, but that event would not adversely affect the customer in the absence of the wager.

40. The staff concludes that a wager is not within the scope of IFRS 4 and is therefore a financial instrument which is within the scope of IAS 32 and IAS 39.

How should wagers be classified under IAS 39?

41. The staff considered how a wager should be classified and measured at and after recognition.

42. IAS 39.9 defines four categories of financial instruments:

    - a financial asset or financial liability at fair value through profit or loss;
    - held-to-maturity investments;
    - loans and receivables; and
    - available for sale financial assets.

43. IAS 39.9 states that:

> 'A financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets either of the following conditions.
>
> (a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:
>
> (i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
>
> (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
>
> (iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).
>
> (b) …'

Does a wager meet the definition of a financial asset or a financial liability at fair value through profit or loss?

44. Whilst this definition was not written with gaming specifically in mind, it can be applied to gaming transactions. In particular, the staff noted that:

- a wager is typically a short-term arrangement which is incurred with a view to being settled in the near-term;
- some gaming institutions will set-off their gaming positions immediately (which could be considered as evidence of short-term profit taking); and
- wagers can be seen as being financial instruments which are managed as a portfolio, and result in short-term profit-taking.

45. In the light of the above the staff considers that, regardless of whether an outstanding wager is a derivative, it is likely to qualify as a held for trading and therefore be classified as a financial asset or a financial liability at fair value through profit or loss.

Is an outstanding wager a derivative?

46. In addition, the staff considered whether an outstanding wager will meet the definition of a derivative instrument. IAS 39 defines a derivative as having 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 (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.

47. The staff considered the example of a spread-bet in which a gaming institution offers a spread of 45-48 on the total number of points in a rugby match. A customer buys for CU10 so, for every point that is scored above 48, the customer wins CU10. For every point less than 45 scored, the customer loses CU10.

48. Such an arrangement will meet the definition of a derivative since its value will alter in response to the forecast total number of points, its initial investment is nil, and it will be settled in cash at a future date.

49. Furthermore, the staff considers that this is likely to hold true for all spread-bets of this nature.

50. The staff then considered the example of an unsettled fixed-odds wager. In this case, the value of the instrument will vary based on changing odds. For example, the fair value of an unsettled CU100 wager with fixed odds of 3:1 will change if the odds which can be obtained by placing a similar wager change to 6:1.

51. The wager will be settled in the future and will therefore meet the definition of a derivative if ‘it requires no initial investment’ or has ‘an initial investment that is smaller than would be required for other contracts that would be expected to have a similar response to changes in market factors.’

52. The staff notes that, unlike a spread-bet, a fixed odds wager has an initial investment. Furthermore, the staff has been unable to identify another contract (other than a wager) which would be expected to have a similar response to changes in market factors as an unsettled wager.

53. IAS 39.AG1 states that, if weather derivatives are not included in IFRS 4, then they are derivative instruments. Similar to wagers, there are no instruments which will give a similar response to market factors as weather derivatives. The staff therefore considers that failure to identify an instrument giving rise to a similar response to market factors does not necessarily preclude an instrument from being a derivative.

54. The staff also believes that, whilst fixed odds wagers have different characteristics to spread bets, there are some similarities between fixed odds wagers and spread bets. In particular:

    a. Fixed odds bets can sometimes also be expressed as spread-bets (for example a spread-betting institution may offer a spread of 0.5-0.8 on a cup final win by one team). Where this is the case, the customer and the gaming institution will both know what they will be required to pay or receive in the case of a victory or loss in exactly the same way as they will for a fixed odds wager. The bet therefore shares some of the characteristics of a spread bet (which the staff has concluded above meets the definition of a derivative) and some of the characteristics of a fixed odds bet. This may imply that fixed odds bets can also be derivatives.

    b. In reality, a lot of spread bets include a cap and a floor beyond which winnings and losses cannot be made. The existence of this cap and floor does not preclude the spread bet from being a derivative instrument. In extreme cases, if the cap and floor are made very narrow, a spread bet may exhibit similar characteristics to a fixed odds bet. Again, this may give evidence that a fixed odds wager has similar characteristics to some types of spread bets and is therefore very similar to a derivative.

55. The staff therefore concludes that, in most cases, a spread bet will meet the definition of a derivative. Similarly the staff believes that a fixed odds wager is

likely to be a derivative. Even if this is not the case, a fixed odds bet is likely to meet the definition of a financial asset or a financial liability at fair value through profit or loss.

56. The staff's analysis therefore supports view 4 above.

Related issues

57. The staff is aware that accounting for wagers as financial instruments may give rise to a number of related questions, for example:

- There may be specific issues associated with determining the fair value of an unsettled wager.
- If gaming institutions account for wagers as financial instruments, it may imply that they should account for net winnings as a gain separate from revenue (with no revenue being recorded).
- Some gaming institutions argue that showing gross bets received less winnings gives customers valuable information about the odds and value offered by different bookmakers. Disclosing only net gains may lose much of this valuable disclosure.

58. The staff has considered each of these below.

Calculating the fair value of an unsettled wager

59. Many bookmakers manage wagers as 'a book' and set odds based on the amounts received to ensure that they will not make a loss. The odds are a reflection of the amounts received on each outcome. For that reason, they may not be a reliable measure of the probability of any particular outcome occurring.

60. Furthermore, in many cases, wagers are placed for irrational reasons. For example, customers will bet for their club or country even though the chances of that club or country winning may be slim. The volume of bets placed in this way may distort odds and could result in erroneous measures of fair value if probabilities of cashflows occurring are based upon published odds.

61. Whilst the staff considers that measuring the fair value of an unsettled wager may present some difficulties, the staff notes that this was not the subject of the submission received by the IFRIC. Furthermore, detailed guidance in this area

is likely to take the form of application guidance rather than an Interpretation. The staff has not therefore considered this issue further.

Presentation of gains separate to revenue

62. The staff is aware of differing views as to how gains from wagers should be presented if those wagers are accounted for as financial instruments. Some believe that, if an entity accounts for wagers as financial instruments, then it should show the net gain in the income statement separate from revenue.

63. The staff considers that an entity should choose the most appropriate manner to present its income statement in line with accounting literature. Given the wide range of differing business models that exist, the staff does not believe it would be appropriate to propose one format for the income statement for all entities which incorporate gaming businesses.

64. The staff has not therefore considered this issue further.

Showing only net gains reduces the usefulness of the financial information to users

65. Some argue that showing gross bets placed, less amounts paid out to equal net gains gives users of the financial statements valuable information. In particular, such disclosure will inform potential customers of the value that a bookmaker gives through its odds and the percentage of gross bets that are returned to customers as winnings. All things being equal, a customer will then be able to choose the gaming institution with the highest payout ratio.

66. The staff agrees that this information may be useful to customers, but notes that, even if an entity is required to disclose its net gains, there is no reason why it cannot provide this information as additional disclosure. During the course of researching the divergence in this area, the staff identified a number of bookmakers who already provide this disclosure voluntarily.

67. Since there is no reason why entities may not provide this additional disclosure, the staff has not considered this question further in this paper.

SHOULD THE ISSUE BE TAKEN ONTO THE IFRIC'S AGENDA?

68. The staff considered the criteria for taking an issue onto the IFRIC's agenda as set out in the IFRIC Due Process Handbook.

Is the issue widespread and practical?

69. The staff notes that the issue only relates to one industry specific topic. In the past the IFRIC have declined to take on industry specific items on the grounds that they are not sufficiently widespread (for example catalogues).

70. In contrast, the gaming industry is a very large and growing industry (particularly with the onset of internet gambling). [Sentence omitted from observer note]

71. The staff considers that, in the light of the wide range of different types of wagers, and the size of the industry, the issue could be considered to be widespread.

Does the issue involve significantly divergent interpretations?

72. The staff has undertaken research into the divergence that exists in practice in this area using publicly available documents and has set out the results of its research in the appendix to this paper.

73. The results of that research indicate that, in situations where gaming entities enter into transactions in which they take a position against a customer and that position remains outstanding at a period end, entities are typically accounting for the outstanding wager as a derivative instrument. Some entities (for example casinos) which have a very short time span between accepting a wager and settling the wager are accounting for net winnings as revenue (without reference to IAS 39). The staff notes that this treatment will result in exactly the same profit being recognised as using IAS 39 when the transactions are settled within the day. The staff therefore considers that this does not give rise to significant divergence in practice.

74. The staff has identified some divergence between casinos which record revenue as the gross amount wagered, and casinos which record revenue as the net gain. Of the fifteen entities reviewed, two recorded revenue as the gross amount received. Whilst the staff considers that this indicates that some divergence does exist, the staff does not consider that this is sufficiently significant to warrant taking the issue on to the IFRIC's agenda.

75. A number of the entities reviewed have made disclosures to the effect that "discussions have continued" within the gaming industry "as to whether gaming

transactions fall within the definition of a financial instrument…The conclusion has emerged that income from gaming transactions should be recognised within IAS 39".

76. These disclosures indicate that the industry is also converging on a model which accounts for wagers as derivative instruments.

77. The staff does not therefore consider that there is significant divergence in practice in this area. To the extent that divergence does exist, the staff considers that the industry is acting to reduce this divergence itself.

Would financial reporting be improved through elimination of the diversity?

78. As discussed above, the staff does not believe that there is significant divergence in practice.

79. The staff does not therefore believe that reporting will be significantly improved by the issuance of an interpretation in this area.

Is the issue sufficiently narrow to be capable of interpretation within the confines of IFRSs?

80. The staff considers that the issue can be resolved within the confines of IAS 18, IAS 32 and IAS 39 as discussed above. The staff therefore concludes that, should the IFRIC wish to take the issue onto its agenda, it would be able to resolve it within the confines of existing IFRS.

Does the issue relate to a current or planned IASB project?

81. The issue may be impacted by either the Board's Financial Instruments or the Board's Revenue projects. Neither of these projects is intending to directly address this issue, and neither is likely to be completed in the immediate future.

Conclusions

82. The staff considers that, in situations where gaming institutions take a position against their customers as a result of a wager, the unsettled wager will usually meet the definition of a financial instrument which should be accounted for in accordance with IAS 39.

83. In situations where gaming institutions do not take a position against the customer but instead receive a commission based on the total amounts wagered,

the commission should be accounted for as revenue and recognised as such when the recognition criteria in IAS 18 are met.

84. The staff does not believe that there is significant divergence in practice in this area and therefore concludes that the IFRIC should not take this issue onto its agenda.

85. [Paragraph omitted from observer note].

Appendix omitted from observer note