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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**October 2008, London**
Project:	**Annual Improvements**
Subject:	**ED Annual Improvements Process – comment analysis: IAS 39 Definition of a derivative (Question 30) (Agenda Paper 8**

INTRODUCTION

1. The purpose of this agenda paper is to summarise the staff's analysis of the comments received on the proposed amendment in Question 30 of the annual improvements ED.

STAFF RECOMMENDATION

2. The staff recommends that the Board not amend IAS 39 by removing from the definition of a derivative the exclusion relating to contracts linked to non-financial variables that are specific to a party to the contract.

BACKGROUND

3. The issue stems from an IFRIC recommendation in its January 2007 meeting that the Board make a minor amendment to paragraph 9 of IAS 39 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.

4. 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.

5. The IFRIC also noted that the definitions of financial and non-financial variables are crucial in determining whether a financial instrument or other contract 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 was highly unlikely to reach consensus on a timely basis on an interpretative issue regarding the meaning of financial and non-financial variables.

COMMENT ANALYSIS

6. Of the 75 comment letters received by the Board, 55 commented on this issue. A majority of respondents did not agree with the proposed changes to the definition of a derivative. Additionally, most respondents (including both respondents who agree and disagree with the proposed changes) "are not of the opinion that this is a minor change that should be addressed as part of the Annual Improvements Process project".[CL11]

7. A majority of the concerns or objections expressed to the proposed amendment arose from the presumption the changes "may broaden the definition of derivatives substantially. This is especially the case in view of IAS 39's requirements on embedded derivatives."[CL14]

8. Many respondents pointed out that the proposed amendment does not address the initial question brought to the IFRIC to provide clarity around 'financial and non-financial variables'.[CL10] Several respondents noted practice has evolved with respect to the meaning of non-financial variables whereby, "this amendment may bring certain contingent derivatives and contracts with clauses referring to non-financial performance variables like EBITDA into the scope of derivatives."[CL28]

9. Several respondents commented on the potential impracticability to accurately calculate the fair value of certain non-financial variables that are specific to a party to the contract and the result being incomparable information across entities.[CL28,35]

Staff Analysis

10. Prior to the issuance of IFRS 4 *Insurance Contracts*, IAS 39 scoped out derivatives based on climactic, geological and other physical variables. Upon issuance of IFRS 4, the scope and definition of IAS 39 were amended to exclude "rights and obligations arising under …IFRS 4 *Insurance Contracts*…" and to amend the definition of a derivative to include the notion of 'non-financial variable that…is not specific to a party to the contract'. Given that insurance contracts are specifically excluded from the scope of IAS 39, it is difficult to determine the Board's intention in amending the definition of a derivative. Likewise, removing the reference to 'non-financial variable' may have broader implications than simply insurance contracts.

11. IFRS 4 states:

> Appendix A. Insurance Contracts. A contract 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.

> B.14. 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 the cash flows from the asset. Conversely, the definition of an insurance contract refers to an uncertain event for which an adverse effect on the policyholder is a contractual precondition for payment. This contractual precondition does not require the insurer to investigate whether the event actually caused an adverse effect, but permits the insurer to deny payment if it is not satisfied that the event caused an adverse effect.

12. Based on the above references within IFRS 4, there are situations currently within the scope of IAS 39 yet excluded from the definition of a derivative that would become derivatives requiring separate accounting under the ED's proposed wording.

13. While 'non-financial variables specific to a party to the contract' is discussed only briefly in IAS 39.AG12A, inferences can be made from other IAS 39 guidance including IAS 39.IG.B.8 and IAS 39.AG33(f)(ii) both indicating that derivatives and embedded derivatives can be based on sales volumes and revenue. Additionally, IAS 39.IG.A.2 discusses an option to put a non-financial asset being a derivative unless it is specifically scoped out of IAS 39 by a purchase, sale or usage requirements contract.

14. Based on current guidance stating that contracts based on sales volumes, revenues and owned property do qualify as derivatives and thereby inferring they are not non-financial variables specific to a party to the contract, it would appear the wording changes as originally proposed in the ED would provide greater consistency throughout IAS 39. However, based on current practice, it appears these references have been narrowly interpreted and similar items like EBITDA

and other earnings performance measures have been deemed to be non-financial variables specific to a party to the contract.

15. To the extent financial instruments fall within the scope of IAS 39, but are not deemed to be derivatives (or not classified as held for trading or the combined instrument is not measured at fair value with changes in fair value recognized in profit or loss), the "day-two" account for the financial instruments would fall under the effective interest rate guidance. Refer to the agenda paper 6 on IAS 39: Application of the Effective Interest Rate Method discussed in the October 2008 Board meeting.

16. Several comment letters received on the Reducing Complexity in Reporting Financial Instruments discussion paper note complexities within the definition of a derivative as well as the current understanding of embedded derivatives. Based on discussions with the IASB financial instruments team, the issue addressed in this ED could be incorporated into the broader project.

17. Potential options for this amendment include the following:

    (a) Approve the currently proposed amendment including all wording changes;

    (b) Provide an answer to the question originally proposed to the IFRIC and define 'financial and non-financial variables'. This could be accomplished by making no changes to paragraph 9 and amending paragraph AG12A of IAS 39;

    (c) Reject the currently proposed amendment and make no plans for future changes; or

    (d) Reject the currently proposed amendment and incorporate this question within the Reducing Complexity in Reporting Financial Instruments project to explore the full implications of any changes to the definition of a derivative.

18. The staff does not support option a as it may have a significant effect on the current definition of a derivative and is therefore should not be included within the annual improvement project. Additionally, it does not address the originally proposed question to provide clarity for 'financial and non-financial variables' which are still referenced in IFRS 4.

19. The staff does not support option c as it does not address the originally proposed question and does not resolve current differences in practice.

20. The staff recommends option d. The staff believes the current ED wording would result in significant changes to the application of IAS 39 that may have not received sufficient analysis given its current incorporation amongst numerous other annual improvements and therefore the proposed amendment should not be approved in its current state. Additionally, the staff recommends incorporating this question within the Reducing Complexity in Reporting Financial Instruments project to ensure the full implications of any changes to the definition of a derivative are understood and re-exposed for comment.

Question for the Board

21. The staff recommends this issue not be addressed within the annual improvements project, but rather it should be considered for incorporation within the Reducing Complexity in Reporting Financial Instruments project.

22. **Does the Board agree with the staff's recommendation? If not, what does the Board recommend and why?**