EFRAG Secretariat: Didrik Thrane-Nielsen, Didier Andries, Galina Borisova

Financial instruments with ESG features – possible alternative approach

Objective

1 The objective of this session is to look at the accounting for combined contracts with a focus on combined contracts where a financial instrument is "considered the main component". For this purpose, two papers are presented. This paper (08-03) is meant for background reading, while paper 08-04 will be used for the discussion.

Relevant requirements in IFRS related to financial instruments and to the accounting for combined contracts

2 Conditions are included in a contract for a purpose. In an agreement between two willing parties any (financial or non-financial) obligation for one party is considered a benefit by the other party (or a benefit relative to the related financial or non-financial obligation imposed on the other party) and vice versa. If a behaviour would have occurred independent of the existence of a contract, rational parties will not include requirement of that behaviour in a contract.

3 Paragraph 11 of IAS 32 *Financial Instruments: Presentation* states that "*a financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity*."

4 Paragraph AG11 of IAS 32 explains that "*Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets. Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset*."

5 It is thus clear that a contract in which one of the parties fulfils its obligation by delivering a non-financial asset or service is not a financial instrument. However, IAS 32 does not comment upon the situation of a combined contract in which one party fulfils its obligations under the contract by paying financial instruments together with delivery of a non-financial asset or service[1]. Implicitly when one party releases some of its obligations under the contract by delivery of a non-financial asset or service the counterparty will be the receiver of such non-financial asset or service.

6 On the separation of components of a contract IFRS has explicit rules in a number of standards including paragraphs 10 and 11 of IFRS 17 *Insurance contracts* (requiring separation of certain non-insurance components), paragraph 12 of IFRS 16 *Leases* (requiring a service component to be separated from a lease contract unless elected by class of underlying assets not to be separated), paragraphs 22 (requiring separate accounting for distinct and dissimilar performance obligations) and 60 (requiring separate accounting for significant financing components) of IFRS 15 *Revenue from Contracts with Customers*. Even IFRS 9 *Financial*

[1] When IAS 32 addresses compound financial instruments it addresses pure financial instrument contracts which for one of the parties contains bout of an equity and a non-equity financial instrument component.

Instruments has rules related to embedded derivatives in chapter 4.3 and considerations given or received for something other than the financial instrument in paragraph B5.1.1.

A number of simplified examples involving contracts with financial instrument components

7 Consider the following contracts involving an asset with a useful life of 10 years:

(a) a contract for the use of the assets in three years where the user at the beginning of each year can elect to either pay a fixed amount in Euro or a fixed amount in NOK.

(b) a contract for the use of the asset in three years where the user, two years before the start of the use of the asset, has prepaid for the right to use the asset.

(c) a prepaid contract for the use of the asset in three years where the <u>user</u> has the right to terminate the contract at the end of year one and year two. If terminated at the end of year one the user has a right to a repayment of 70% of the prepayment and if terminated after year two 36,75% of the prepayment.

(d) a prepaid contract for the use of the asset in three years where the <u>provider</u> has the right to terminate the contract at the end of year one and year two. If terminated at the end of year one the user has a right to a repayment of 70% of the prepayment and if terminated after year two 36,75% of the prepayment.

(e) a prepaid contract for the use of the asset in three years where the <u>provider</u> has the right to terminate the contract at the end of year one and year two. If terminated at the end of year one the user has a right to an immediate repayment of 100% of the prepayment and if terminated after year two the user also has a right to an immediate repayment of 100% of the prepayment.

(f) a prepaid contract for the use of the asset in three years where the <u>provider</u> has the right to terminate the use of the asset at the end of year one and year two. If terminated at the end of year one the user has a right to a repayment of 5% of the prepayment at the end of year two and 105% of the prepayment at the end of year three, and if terminated after year two 105% of the prepayment at the end of year three.

8 It may be argued that contract:

(a) looks like a lease contract with an embedded currency derivative which according to paragraph B4.3.8(d) of IFRS 9 is to be separated.

(b) looks like a lease contract with an embedded financing component. Paragraph 24(b) of IFRS provides indications for not calculating interest on the embedded financing component.

(c) looks like a lease contract with an embedded financing component (the prepaid amounts for the years not yet started). Paragraph 24(b) of IFRS 16 provides indications for not calculating interest on the embedded financing component. The repayment amounts are set so that it must be considered if the lease term is one year rolling.

(d) looks like a lease contract with an embedded financing component (the prepaid amounts for the years not yet started). Paragraph 24(b) of IFRS 16 provides indications for not calculating interest on the embedded financing component. The lease term is three years.

(e) looks like the contract above, but also, and maybe more so, looks like a loan to the owner of the asset where the interest on the loan is paid by the credit provider being allowed to use the asset.

(f) looks like the contract above but looks even clearer like a loan to the owner of the asset where the interest on the loan is paid by the credit provider being allowed to use the asset.

9 It may be argued that the economic reality is that all the above constructed examples describe combined contracts consisting of a lease and a financial instrument component. It may also be argued that with minor adjustments to the fact pattern all the above examples could be made to examples of combined contracts consisting of a service and a financial instrument.

10 It may be argued that in the first four examples the non-financial component may be considered the main component while in the two last examples the financial instrument component may be considered the main component.

11 While IFRS 9 provides clear guidance for the separation of components in the first example (IFRS 9.B4.3.8(d)), IFRS 9 is less clear on the separation for the remaining examples. It may be argued that paragraph B5.1.1 of IFRS 9 is applicable to the two last examples.

12 Transactions can appear in many shapes and forms. In a voluntary market-based transaction one party may deliver a service, a non-financial asset, a financial asset, a promise of a service, a non-financial asset, a financial asset or any kind of combinations of these and may receive a service, a non-financial asset, a financial asset, a promise of a service, a non-financial asset, a financial asset or any kind of combinations of these.

13 Simple transactions involving only exchange of a service or a good against a financial asset or a financial asset against another financial asset may be regulated in only one IFRS standard. Complex transaction involving exchange of combinations of current and future deliveries of services, non-financial assets and financial assets may be regulated in multiple IFRS standards. In such situations the correct identification and separation of the different components of a transaction becomes important.

14 In some situations, it may be difficult to demonstrate that one party has received goods or services. IFRS 2 *Share-based Payments* provides explicit guidance when share-based payment transactions are involved and may through the guidance in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* be applicable also in other situations.

How may the thinking about combined contracts help the accounting for complex contract with non-financial obligations?

15 A financial instrument as defined in IAS 32 is a pure exchange of a financial asset against a financial liability and or an equity instrument. It follows directly or indirectly from IFRS 2 that if a contract obliges one party to deliver a good or a service the counterparty has received a good or a service when and if the delivery takes place.

16 A contract for which the obligations under the contract may fully or partly be discharged by the delivery of goods (non-financial assets) or services is a non-financial contract or contains a non-financial component. The accounting for such a contract would be expected to be fully or partly found outside the requirements for the accounting for financial instruments in IFRS 9. However explicit guidance may point to IFRS 9 (e.g., IFRS 9.2.1(b), IFRS 9.2.1(j), IFRS 9.2.5 to 2.7 and IFRS 9.4.3.5).

17 In a contract it is important to identify the rights and obligations of each party and to consider whether these rights and obligations are consistent with those of a financial instrument or whether these rights and obligations are of a non-financial nature. If the rights or obligations for one party in a contract are of a financial and non-financial nature, the issue becomes if and how to separate these rights or obligations into components representing a financial instrument and one or more non-financial contracts.

18 Concluding, the EFRAG Secretariat is of the view that he financial and non-financial component of a combined contract are components or sub agreements that are entered into in contemplation of another. The requirements related to contracts entered into in contemplation of each other will apply.

19 Non-financial rights and obligations that have no other objective than to support a financial instrument may be considered an integral part of that financial instrument.