EFRAG Secretariat: Didrik Thrane-Nielsen,
Aleksandra Sivash, Juan José Gómez

Objective

1 The objective of this paper is to present to the FRB members the comments received from the FR TEG members on the alternative model discussed in agenda paper 06-02 and related EFRAG Secretariat considerations. The comments were gathered during the ad-hoc FR TEG meetings on March 5 and 6, 2024.

Summary of the FR TEG comments and EFRAG Secretariat considerations

Below is the summary of the improvements or issues identified by the EFRAG FR TEG members in relation to the alternative model (in no specific order of priority or importance):

2 *Complexity of the model especially in case of a large number of contracts and multiple changes in estimates throughout the life of the contract(s).*

- ⇨ The alternative model is principle-based and therefore can be applied to a large number of contracts and situations (it is not limited to PPAs). The complexity will therefore be directly correlated to the complexity of the underlying contract. The duration of the contract will have a direct impact on the changes in estimates throughout the life of the contract. EFRAG Secretariat believes that the benefits of a flexible model allowing for changes in estimates and circumstances (and thus better depicting the economic reality of an entity) would outweigh the costs associated with the complexity of the model. To assume that a contract for multiple different underlying is a contract for a reduced set (one or two) homogeneous underlying creates reduced complexity at the cost of faithful representation and thus possibly relevance.

3 *Interaction with other IFRS guidance related to the Unit of Account notion and conceptually justification of the split to be added.*

- ⇨ The EFRAG Secretariat prepared an Appendix A below summarising current IFRS guidance on split accounting.

4 *Further considerations about how the units of account or portions of the contract are identified and measured.*

⇨ The EFRAG Secretariat prepared an Appendix B below with considerations regarding the identification and measurement of units of account.

5 *To include in the illustrative example situations when there are differences between the estimates and the actual realisation of those estimates (experience adjustments considerations).*

⇨ The EFRAG Secretariat will prepare additional illustrative examples at a later date.

6 *To reflect on the possibility to present the changes in estimate on a net basis vs gross basis (ex. change of the maintenance period from March to June).*

⇨ Conceptual Framework para 4.54: *"Treating a set of rights and obligations as a single unit of account differs from offsetting assets and liabilities".* Conceptual Framework para 7.10: "*Offsetting occurs when an entity recognises and measures both an asset and liability as separate units of account, but groups them into a single net amount in the statement of financial position".*

In case of the financial assets and financial liabilities, offset is possible only when an entity […] "*intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously"* (IFRS 32 para 42). In our alternative own-use example, it is not expected that the settlement of the PPA in March and in June (both maintenance periods) will be done on a net basis or simultaneously.

7 *To clarify the periodicity of rebalancing / assessment of the estimates.*

⇨ Clarification included in the proposed paragraph 2.4B within the agenda paper 06-02 (assessment is to be considered as a minimum at the end of each financial reporting period).

8 *Better explanation of the key features of the model, in particular the fact that when a part of the contract no longer qualifies for the own-use exception and comes in scope of IFRS 9, the related fair value is taken to Profit or Loss and when the IFRS 9 is no longer applied because the part of the contract becomes eligible for the own-use exception, the fair value is frozen in the Balance Sheet and is further amortised over the relevant period.*

⇨ The EFRAG Secretariat included a summary of the key features of the model within paragraphs 2 – 13 in the agenda paper 06-02.

9 *Comparative analysis of other alternatives like all-in-one hedge.*

- An all-in-one hedge was described in Guidance on Implementing IAS 39 F.2.5. When implementing IFRS 9 the IASB decided to not carry forward any of the hedge accounting related Implementation Guidance that accompanied IAS 39. However, the IASB emphasised that not carrying forward the Implementation Guidance did not mean that it had rejected that guidance (IFRS 9 BC6.95). F.2.5 of IAS 39 stated that a derivative instrument that will be settled gross can be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the future transaction that will occur on gross settlement of the variability in the purchase or sale price without the derivative. F.2.5 claimed that this applies to all fixed price contracts that are accounted for as derivatives under IAS 39. The example in F2.5 is an entity who enters into a fixed price contract to sell a commodity and that contract is accounted for as a derivative under IAS 39, the entity may designate the fixed price contract as a cash flow hedge of the variability of the consideration to be received on the sale of the asset even though the fixed price contract is the contract under which the asset will be sold.
- The all-in-one hedge is not a solution to extend the own-use, but it may be a subsequent solution to those contracts that fail own-use. It is not a solution to vPPAs as they do not have the gross settlement.
- The own-use guidance is now no longer a part of the IFRS accounting literature, although the IASB has not rejected the guidance. The statement in F.2.5 on the all-in-one hedge applicability to all fixed price contracts that are accounted for as derivatives might be due to an oversight of load following swaps. If not the issues of load following swaps should have been solved with a reference to this sentence.

10 *To elaborate on how the current guidance of IFRS 9 and the definition of the own-use exception (to be entered into and held for) agrees (or does not agree) with the possibility given by the alternative model to fall under the own-use exception after the original assessment and reasons thereof.*

- The alternative model is different from the current guidance as it is forward-looking and allows for the changes in estimates. Therefore, the condition "were entered into" is not required in the alternative model.

  However, this does not contradict the IFRS 9 BCZ2.18 which is focusing on the forward-looking element when it is stating:

"Before the amendments in 2003, IAS 39 and IAS 32 were not consistent with respect to the circumstances in which a commodity-based contract meets the definition of a financial instrument and is accounted for as a derivative. The IASB concluded that the amendments should make them consistent on the basis of the notion that a contract to buy or sell a non-financial item should be accounted for as a derivative when it (i) can be settled net or by exchanging financial instruments and (ii) <u>is not held for the purpose</u> of receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements (a 'normal' purchase or sale). …"

The current text in IFRS 9 is both forward- and backward-looking when it comes to own-use. Using the text in IFRS 9 BCZ2.18 there may however be made an argument that also in IFRS 9 the most important piece is the forward-looking element which is the only element kept in the alternative model.

11 *To see if the model is workable from the point of view of preparers and how predictive the model can be.*

⇨ Similar to the comment on complexity of the model, the notion of the model being "workable" from the point of view of preparers will depend on the underlying contract and its complexity. From the point of view of predictability, for the parts of the contract measured at fair value, the fair value measurement includes all future cash flows associated with the underlying therefore it is believed to provide the most predictive information at that point in time. The fact that the contract may be split in various units of account improves, in the EFRAG Secretariat view, the predictability as it allows the entity to specify which part it intends to consume as own-use and which part will be impacting the PL through fair value changes. The changes of fair value themselves will depend on the volatility of the underlying market prices and are not impacted by the model as such.

12 *Better explanation on how the non-derivative asset or liability meets the definition of asset or liability.*

⇨ An asset is a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits. A liability is a present obligation of the entity to transfer an economic resource as a result of past events. Both cases (assets and liabilities), the contract or parts of a contract which exit the scope of IFRS 9 and are accounted for as a non-derivative asset or liability at their fair value at the moment of qualifying for the own-use exemption (frozen faire value as deemed cost) meet the definition of asset or liability as outlined in the Conceptual Framework. A contract, or part of a contract provides certain rights to the parties of that contract and fixes related obligations. By analogy, the assessment is similar to purchase or sale of an executory contract in a secondary market.

13 *To consider the ''disciplinary action'' in situations when the estimates differ considerably from the actual experience (ex. disclosure requirements).*

- ⇨ Enforcement is most effectively handled by audit and enforcement. If "disciplinary actions" is required then this should be made through disclosure requirements relating to changes in own-use assessments and explained true-up on own-use assessments against actual own-use in the accounting period.

Appendix A - Where and how is «split accounting» applied in IFRS?

14 Conceptual Framework provides examples of possible units of account being:

i) an individual right or individual obligation;

ii) all rights, all obligations, or all rights and all obligations, arising from a single source, for example, a contract;

iii) a subgroup of those rights and/or obligations—for example, a subgroup of rights over an item of property, plant and equipment for which the useful life and pattern of consumption differ from those of the other rights over that item;

iv) a group of rights and/or obligations arising from a portfolio of similar items;

v) a group of rights and/or obligations arising from a portfolio of dissimilar items—for example, a portfolio of assets and liabilities to be disposed of in a single transaction; and

vi) a risk exposure within a portfolio of items—if a portfolio of items is subject to a common risk, some aspects of the accounting for that portfolio could focus on the aggregate exposure to that risk within the portfolio.

15 IFRS 9 has the concept of separate accounting for parts of a contract that is "something other than the [financial] instrument", where the something other "is an expense or a reduction of income unless it qualifies for recognition as some other type of asset". (IFRS 9.B5.1.1) This may however be overruled by the requirement in IAS 32.AG23 to consider a contract that contains both a financial and a non-financial component as a financial instrument.

16 IFRS 9 has the concept of separate accounting for embedded derivatives. (IFRS 9 chapter 4.3)

17 IFRS 9 has the concept of accounting for proportions, layers and separate risks in financial instruments when conducting hedge accounting. (IFRS 9 chapter 6)

18 IFRS 9 has the concept of accounting for separate cash-flows when it comes to derecognition. (IFRS 9.3.2.2(a) and IFRS 9.3.2.16-21)

19 IFRS 15 has the concept of accounting separately for separate performance obligations in a contract. (IFRS 15.22)

20 IFRS 15 has a concept of accounting separately for financing components in a contract for delivery of a non-financial good or service. (IFRS 15.60).

21 IFRS 16 has the concept of accounting separately for lease and non-lease components of a contract (IFRA 15.12).

22 IFRS 17 has an entire chapter on separating components from insurance contracts. (IFRS 17.10-13).

23 IFRS 18.B97 / IAS 1.71 require «the current portion of non-current financial liabilities» to be presented as current liabilities. Thus, there is for presentation purposes an obligation to split liabilities into a current and a non-current portion for presentation purposes.

24 IAS 16 has the concept of splitting a property, plant or equipment in multiple parts for the calculation of depreciation (IAS 16.43)

25 IAS 32 has the concept of separate accounting for a component part of a financial instrument as either asset, liability or equity and subsequently account for these components as financial assets, financial liabilities or equity. (IAS 32.15 and IAS 32.28-32)

26 IASB is contemplating separating RECs from PPAs as the accounting for RECs in a PPA is separated from the project of accounting for PPAs.

27 If a PPA is within the scope of IFRS 15 then each trading unit of electricity in the PPA will be a separate performance obligation as each trading unit of electricity is distinct. The customer can benefit from each trading unit on its own and each trading unit of electricity is separately identifiable from other promises in the PPA. The same go for every REC in the PPA.

Appendix B – Identification and measurement of units of account

28 As it relates to the identification of the units of account, all IFRS Standards outlined in the Appendix A above provide a guidance on the identification and measurement of the components or parts of contract.

29 Therefore, the analysis needs to be performed based on the facts and circumstances of the specific contracts and applicable IFRS guidance.

30 For example, IFRS 15 provides guidance related to the identification of a performance obligation, which consists of distinct goods or services or a series of distinct goods or services that are substantially the same.

31 For illustrative purposes, applying the guidance in IFRS 15 to the Power Purchase Agreement (fact pattern presented in the agenda paper 06-03 providing illustrative example), since electricity is delivered on the market every 15 minutes (depending on the market between 6 min and 1 h in Europe) and the settlement takes place based on the

intervals of delivery (also 15 minutes in our example), each unit so delivered is a separate performance obligation (with distinct delivery and distinct settlement based on the contract price and / or spot price for that 15-minute interval).

32 Further, it is possible to combine the series of distinct goods or services that are substantially the same, the EFRAG Secretariat differentiates then a performance obligation which combines all deliveries of electricity which are for the own-use (which are delivered and consumed) and all deliveries of electricity which are expected to be sold back on the market (weekends and maintenance period in our example).

33 In addition, as per IFRIC June 2023 para 50 describing the net pool market predominant in Europe: “If the customer is not able to clear its account by consuming the electricity within that time interval, the surplus is transacted through a voluntary pool mechanism at the spot prices. Typically, the electricity customers engage third parties to sell surplus energy delivered to them...”

34 Therefore, the unsold volumes are subject to a dedicated agreement governing the sale-back, which in itself, constitutes a separate performance obligation to the parties of that agreement.

35 In terms of measurement of the parts of the contract, IFRS 15 para 73 states: “The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer”.

36 Therefore, in case of PPA in our example, each part of a contract needs to be measured separately in a way that the transaction price is allocated to each performance obligation.

37 At inception of the contract (PPA), it is assumed that the fair value of the contract is 0. The fair value of each part of the contract is either 0 (less likely) or needs to be measured separately applying either (a) or (b) of the IFRS 9 para B5.1.2A.

38 IFRS 9 para B5.1.2A states:

The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also IFRS 13). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 5.1.1A, the entity shall account for that instrument at that date as follows:

(a) at the measurement required by paragraph 5.1.1 if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.

(b) in all other cases, at the measurement required by paragraph 5.1.1, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.

39 At subsequent measurement, IFRS 9 B5.2.2A states:

The subsequent measurement of a financial asset or financial liability and the subsequent recognition of gains and losses described in paragraph B5.1.2A shall be consistent with the requirements of this Standard.