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Way forward for Discussion Paper on variable consideration Issues Paper

Objective

1 At the 3 – 4 March 2021 EFRAG TEG meeting, EFRAG TEG members were asked to identify approaches to account for variable consideration which could be expected to receive some support from constituents. The EFRAG Secretariat has tried to reduce the number of possible approaches to account for variable consideration to be included in EFRAG's Discussion Paper on how to account for variable consideration. The reduction has been made for the purpose of simplifying the Discussion Paper. The simplifications related to recognition of a liability for variable consideration have been included in the outlined Discussion Paper. For other simplifications, this issues paper asks for directions.

2 The objectives of this issues paper are accordingly to:

(a) Receive input from EFRAG TEG on the first two chapters of the Discussion Paper on the accounting for variable consideration;

(b) Receive direction from EFRAG TEG on the chapters of the Discussion Paper on:

(i) Measurement of a liability for variable consideration; and

(ii) Measurement of goods and services received in exchange for variable consideration.

Background and purpose of this paper

3 EFRAG is developing a Discussion Paper on the accounting for variable consideration for acquired goods or services outside of a business combination.

4 Current IFRS Standards do not provide a set of similar principles on the accounting for variable consideration for goods or services acquired. The dissimilar treatments are, according to the EFRAG User Panel, not beneficial. It also makes it very challenging for preparers of financial statement to develop an appropriate accounting policy for the recognition of a liability for variable consideration by analogy when specific guidance is not provided in a Standard covering the particular liability. The issue becomes more prevalent given the recent change to the definition of a business in IFRS 3 and the likelihood of an increase in asset acquisitions (that were previously accounted for as businesses). Variable consideration can compromise a significant component of the consideration paid for acquired goods or services including acquisitions of assets that are not considered a business under IFRS 3 *Business Combinations.* The amendments to IFRS 3 published in October 2018 and effective for annual reporting periods beginning on or after 1 January 2020 could result in fewer business combinations being recognised. The likely increase

in asset acquisitions, could also mean that more questions may arise on the accounting for variable consideration.

5 At several occasions, the IFRS Interpretations Committee ('the Interpretations Committee') has discussed issues related to variable consideration and it appears from the "accounting manuals" of big audit firms that they have different views on how to account for variable consideration. Different views on variable consideration have also been expressed by IASB members.

6 The Discussion Paper considers situations where an entity is acquiring goods or services, and the amount of consideration (or part of) an entity will pay for the goods or services depends on one or several factors for which the outcome is not known at the time the goods or services are acquired. The factors can both be within or outside the control of the entity that is acquiring the goods or services.

7 Variable consideration could also exist in the case where the consideration is determined before the acquired goods or services are transferred. This could, for example, be the case if a party has ordered 100 doses of a particular drug, and it has been agreed that the consideration will depend on how effective the drug is. The effectiveness of the drug is determined by a laboratory, and when that is determined, the consideration would be paid although the drug will be delivered at a future date.

8 EFRAG's Discussion Paper will consider:

(a) When a liability for variable consideration should be recognised;

(b) How the liability for variable consideration should be measured; and

(c) How the amount for variable consideration should be reflected in the initial and subsequent measurement of the goods or services acquired.

9 In addition, the Discussion Paper will include a section on how to account for value changes of the assets that have to be transferred (that is, changes related to the value of the assets to be transferred and not the number/amount of assets to be transferred). At a later stage, EFRAG TEG will also be asked whether the Discussion Paper should consider disclosures on variable consideration.

10 Variable consideration arising in business combinations is outside the scope of the Discussion Paper. The reason is that there would be special issues related to allocating any changes in the consideration for the business to the various assets of that business.

11 Furthermore, the Discussion Paper will not consider what type goods or services are being exchanged in a contract involving variable consideration. For example, if an entity is acquiring 'something' involving a machine and the consideration depends (fully) on the number of widgets the entity is producing using the machine, a question could arise about whether the entity is buying the machine or has just agreed to pay a given amount for each widget it is producing using a machine made available by the "seller". Such issues were considered in a draft discussion paper developed by the UK FRC that EFRAG TEG has previously discussed.

12 In the Discussion Paper EFRAG is developing, it is assumed that it is known what is acquired. Accordingly, if the consideration an entity will pay for a machine (and nothing less, nothing more) depends on the number of widgets produced on the machine, the consideration is regarded as variable. If, on the other hand, an entity

is paying e.g., EUR 2 for each widget it produces on a machine made available to the entity, the consideration for the production of each widget is not variable.

Structure and scope of this issues paper

13 The EFRAG Secretariat's analyses and suggestions on the recognition of a liability for variable consideration (see paragraph 8(a) above) are reflected in Chapter 2 of the outlined Discussion Paper (Agenda Paper 02-03). A summary of the suggested approaches is provided below.

14 For the issues of measuring the liability for variable consideration (see paragraph 8(b) above) and the goods or services received in exchange for variable consideration (see paragraph 8(c) above), this issues paper asks for EFRAG TEG members' comments on proposed directions of the EFRAG Secretariat.

15 The three issues mentioned in paragraphs 8(a) - 8(c) above are considered in the following three sections.

16 This issues paper and the outlined Discussion Paper do not consider payments by means an entity's own equity interests. This will be considered at a later stage (unless EFRAG TEG considers that this should be excluded from the scope of the Discussion Paper).

Purpose of the Discussion Paper

17 One of the purposes of the Discussion Paper is to develop a number of accounting alternatives to account for variable consideration. For example, Chapter 2 of the outlined Discussion Paper includes proposals for when to recognise a liability for variable consideration. The proposed guidance, for example, provides a suggested answer to the question IASB members have expressed different views about, and which has prevented the IFRS Interpretations Committee from reaching a view on how to account for variable consideration for PPE and intangible assets: whether variable payments linked to future performance or use of an underlying asset meet the definition of a liability.

18 The proposals in the Discussion Paper will inevitably be in conflict with some specific current guidance on how to account for variable consideration in specific cases. This will be the case as current guidance is different. The EFRAG Secretariat accordingly proposes that the proposals in the Discussion Paper be considered as principles for accounting for variable consideration. That is, the proposals should be regarded as guidance for consistent standard-setting, but that standard-setters could deviate from these principles.

Question for EFRAG TEG

19 Does EFRAG TEG agree with the suggestion included in paragraph 18?

Recognition of a liability for variable consideration (Chapter 2 of the Discussion Paper)

20 Chapter 2 of the outlined Discussion Paper considers three issues related to the recognition of a liability for variable consideration:

(a) The **unit of account** to be considered when assessing whether:

   (i) the definition of a liability is met; and

   (ii) any recognition criteria are met.

(b) When a liability exists; and

(c) Whether a (possible) liability should only be recognised when certain criteria are met.

The unit of account

21 Chapter 2 of the Discussion Paper notes that the unit of account to assess whether the definition of a liability is met seems to be each economic resource (e.g., each unit of currency) the entity might have to transfer. The Discussion Paper proposes that if an entity may have to transfer additional assets in exchange for a good or service, the (possible) obligation to transfer additional assets should be considered as a separate unit of account for recognition purposes. That is, if the entity, for example, would have to pay a fixed amount in euro and a possible additional variable amount in euro, **then the additional variable amount in euro should be considered as a single unit of account**. The main reason for this proposal is that if the variable part should be considered together with the fixed part, adding a (negligible) fixed component to a variable consideration could have significant implications for the accounting without having real economic effect if, for example, a recognition criterion would be that it should be probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

When a liability exists

22 Chapter 2 of the Discussion Paper proposes that the definition of a liability and the supporting guidance in the *Conceptual Framework for Financial Reporting* should be applied to determine when a liability to pay variable consideration exists. This would mean that if a variable payment would depend on a future action an entity may or may not take, a liability would generally only exist if the entity has no practical ability to avoid taking that action.

23 Whether a liability for variable consideration exists, will depend on facts and circumstances and it may sometimes be uncertain whether the entity has an obligation. According to the Conceptual Framework, this could be a reason to include recognition thresholds.

Recognition thresholds

24 The Discussion Paper discusses when a liability for variable consideration should be recognised. It considers various possible recognition criteria, but suggests that only two approaches are further analysed:

(a) No recognition threshold (i.e. all liabilities for variable consideration are recognised (if they can be measured reliably)) (similar to, for example, IFRS 9 *Financial Instruments)*;

(b) A recognition threshold based on a probability threshold under which a liability is only recognised if it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation (similar to, for example, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*). According to the Conceptual Framework for Financial Reporting, when there is uncertainty about the existence of a liability (see paragraph 23 above), possible combined with a low probability of outflows of economic benefits and an exceptionally wide range of possible outcomes, may mean that the recognition of an asset or liability, necessarily measured at a singe amount, would not provide relevant information.

Questions for EFRAG TEG

25 Does EFRAG TEG agree with the proposals of the EFRAG Secretariat included in Chapter 2 of the outlined Discussion Paper and summarised in paragraphs 21 - 24 above regarding:

(a) The unit of account;

(b) How to assess whether a (possible) obligation is a liability;

(c) Recognition of a liability (in relation to recognition criteria, do you think that other approaches (e.g. any of those listed in the section 'Other approaches not considered in this discussion paper' should be considered)?

26 In the outlined Discussion Paper, the unit of account issue is considered in the chapter dealing with recognition of a liability for variable consideration. Does EFRAG TEG agree with including the discussion in that chapter, or would EFRAG TEG prefer a separate chapter on the unit of account?

Measurement of a liability for variable consideration

27 The outlined Discussion Paper does not yet include a chapter on how to measure a liability for variable consideration. The EFRAG Secretariat is asking EFRAG TEG for input on which approaches to measurement it would be relevant to consider (that is, which approaches to measurement could be assumed to receive some support).

28 Currently, the measurement of a liability for variable consideration depends on which IFRS Standard the liability would be included in. For example, whether it would be a liability covered by IAS 19, IAS 37, IFRS 2, IFRS 9, IFRS 16 or IFRS 17. This means that liabilities for variable consideration are accounted for differently depending on their classification and the applicable IFRS Standard.

29 To the extent that the measurement of the acquired goods or services would reflect the measurement of the related liability, this would also mean that goods or services could be measured differently depending on the type of consideration used to acquire the goods or services.

30 To deal with this issue, it could be considered to introduce a general measurement approach for variable consideration liabilities. The EFRAG Secretariat considers that there could be two approaches which could receive some support:

(a) Fair value measurement approach - An approach under which a liability related to variable consideration is measured at fair value (similar to IFRS 3 and IFRS 9 for derivatives); and

(b) Cash-flow measurement approach - An approach under which a liability is measured at the most likely amount or expected value depending on which method the entity expects to better predict the amount of consideration it will have to transfer (similar to IFRS 15 and the proposals for measurement of regulatory assets and regulatory liabilities).

31 Although the EFRAG Secretariat considers that other measurement bases could also be suitable to measure liabilities for variable consideration, it notes that the suggested two approach are already part of common practice. Having said this, the EFRAG Secretariat notes that in the past, there has been European opposition against measuring provisions covered by IAS 37 at fair value mainly because the measurement bases should reflect what the entity expects to settle, rather than driven by a market participant value.

32 Measuring liabilities for variable consideration using the cash-flow measurement approach mentioned in paragraph 30 may not reflect how liabilities for variable consideration are currently measured to the extent they fall under, for example,

IFRS 9. However, it might be argued that measurement at both fair value and amortised cost are methods reflecting an expected value. Accordingly, if it could be argued that expected value is the method that would best predict the amount of consideration an entity would have to transfer when the variable consideration liability is a financial instrument, some might argue that the approach mentioned in paragraph 30(b) could work without resulting in too radical changes in how liabilities are currently measured.

Question for EFRAG TEG

33 Does EFRAG TEG agree with the two proposed measurement bases in paragraph 30? If not please explain why. Are there other approaches you consider should be discussed in the Discussion Paper?

Measuring a good or service acquired for variable consideration

34 The Discussion Paper will also cover the measurement of the goods or services acquired for variable consideration to the extent that the goods or services are measured at cost – both initially and subsequently.

35 The **main issue in relation to variable consideration is whether an update of the measurement of the liability for variable consideration should be reflected in the subsequent measurement of the acquired goods or services.**

36 The EFRAG Secretariat proposes that two options could be considered further in the Discussion Paper. Under both approaches the initial measurement of the liability for variable consideration is reflected as part of the initial cost of the acquired goods or services. However, subsequently:

(a) Changes in measurement recognised in profit or loss - Under the first approach the cost of a good or a service would not be updated following changes in the related liability (this corresponds to the current requirements in IFRS 9 and results in the changes in the measurement of the variable consideration liability being immediately reflected in the statement of comprehensive income);

(b) Changes in measurement recognise as part of the underlying acquired goods or services - Under the second approach the cost of a good or a service is updated (this corresponds to the current requirements in IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*).

37 In the paper for the 3 – 4 March 2021 EFRAG TEG meeting (see paragraph 3 above) an additional approach was included under which the measurement of the acquired goods or services **would only be updated to the extent that the variability would be related to the goods or services (for example the performance of the goods or services).**

38 This approach is suggested not to be considered as an option in the Discussion Paper primarily because:

(a) The number of alternatives presented in the Discussion Paper should be limited.

(b) In practice it can be difficult to objectively determine whether the variability would be related to the goods or services. For example, when the variability partly depends on the performance of the good or service and partly on other factors.

(c) Of conceptual reasons. The purpose of the approach is to cater for the cases where variable consideration is introduced because, for example, the quality of the good or service received is not completely known at the time when the good or service is received. The variable consideration it thus introduced to ensure that the price for the good or service acquired is “the right price for what has been acquired”. There could, however, be other factors than those related to the good or service or the performance of the good or service that would determine what “the right price for the good or service acquired” would be. For example, “the right price” could also be the price for similar transactions on the transaction day (which would only be known days after the transaction took place). Accordingly, variable consideration that would depend on what similar goods or services are sold for in a given period, could also be argued to relate to finding “the right price for what has been acquired”. It could thus be argued that this variability should also be reflected in the measurement of the acquired good or service although the variability does not relate to the good or service or the performance of the good or service.

39 Other approaches for whether changes in the measurement of a liability for variable consideration should be reflected in the measurement of the acquired goods or services, EFRAG TEG may consider, would be:

(a) An approach under which changes in the measurement of a liability related to variable consideration would be included in profit or loss of a given period if the change relates to that period;

(b) An approach under which the nature of the adjustment to the measurement of a liability is considered (e.g. does it reflect a volume discount or does the adjustment reflect that uncertainties about the quality of the goods or services received have been resolved – in which case the change should be reflected in the measurement of the received goods or services);

40 If in a transaction I acquire an asset but don’t want to be exposed to the variability of the asset due to events occurred under the control of the seller (e.g. loan portfolio for which the amount of credit losses are unknown but depend on credit granting decisions of the seller, I would negotiate a price adjustment that the seller will indemnify me about this variability. In this case I would say that the change has to adjust the initial cost of the asset.

Question for EFRAG TEG

41 Does EFRAG TEG agree with the two suggested measurement approaches regarding the underlying acquired goods or services? If not please explain why.

Other issues and comments to the outlined Discussion Paper

Question for EFRAG TEG

42 Does EFRAG TEG have other comments to Chapter 1 and Chapter 2 of the outlined Discussion Paper?