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European Financial Reporting Advisory Group

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DISCUSSION PAPER

ACCOUNTING FOR VARIABLE CONSIDERATION

[MONTH AND YEAR OF PUBLICATION]

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EFRAG welcomes comments on its proposals via the 'Questions to Constituents' at the end of each section. Such comments should be submitted through the EFRAG website by clicking [*here-insert hyperlink*] or should be sent by post to:

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This paper is part of EFRAG's research work. EFRAG aims to influence future standard-setting developments by engaging with European and international constituents and providing timely and effective input to early phases of the IASB's work. Four strategic aims underpin proactive work:

- engaging with European constituents to understand their issues and how financial reporting affects them;
- influencing the development of International Financial Reporting Standards ('IFRS Standards'), including through engaging with international constituents;
- providing thought leadership in developing the principles and practices that underpin financial reporting; and
- promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our research work and current projects is available on EFRAG's website.

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CHAPTER 1: BACKGROUND AND SCOPE

Guidance on how to account for variable consideration is dissimilar and variable consideration is accordingly accounted for in different manners. This Discussion Paper considers whether/when to recognise a liability for variable consideration, how to measure a liability for variable consideration and how to measure initially and subsequently goods and services acquired for variable consideration when these goods and services are measured at cost.

Why is consideration sometimes variable?

1.1 In many transactions, the consideration to be paid is not a fixed amount. Instead the amount to be paid — in cash or by transferring a non-cash asset — varies with factors related to the good or service acquired, to one of the parties in the transaction and/or to something unrelated to these. In other words, the consideration is variable.

1.2 Variable consideration can be introduced for many different purposes. For example:

a) When the **quality of a good or service** including how much profit it can generate is unknown at the date of the transaction, the consideration could be variable to reflect the quality of the good or service as it will become apparent. For example, a seller of a plot of land which contain an unknown amount of gold could find it difficult to sell the land at a price reflecting the seller's (optimistic) estimates of the amount of gold available. In order to attract more pessimistic buyers, it could therefore be agreed that the price of the plot of land would depend on how much gold the buyer would find on the land. Similarly, if there is uncertainty about how much profit a good can generate, either the buyer or the seller can diversify risk by variable consideration. For example, a seller can diversify risk by selling a good at a discount but retaining a right to additional consideration if the income generated by the good exceeds a certain threshold. Similarly, a buyer can diversify risk by agreeing that the consideration to be paid in return for the good should depend on the income generated from the good.

b) When a seller wants to **stimulate sales**, the consideration of all the goods a particular buyer buys within a year could vary with the total number of goods purchased within a year.

c) When one party wants to **retain some of the risks and rewards** related to a good, but cannot afford to maintain and/or develop the good, that party can transfer the good to another party in return for a consideration that will depend on the performance of the good transferred (or the further developed good).

d) When a buyer does not trust the **seller's estimate of the value** of an asset, the consideration to be paid in return for the asset could be set to vary depending on the income generated from the asset or on the outcome of a due diligence carried out by the buyer.

What are the accounting issues with variable consideration?

1.3 Current IFRS Standards do not provide a set of similar principles on the accounting for variable consideration for goods and services acquired. They also seldom explain the reasons for the different requirements. The dissimilar treatments may make it difficult for users of financial statements to determine the debt position of a company at a point in time which also affects the relevant measures and ratio analysis.

1.4 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). This is because specific guidance exists for variable consideration in a business combination, but in general not for assets acquired outside a business combination. For example, the change in the definition is likely to result in more asset purchases in the pharmaceutical sector, where consideration for asset acquisitions are often subject to significant amounts of variable consideration.

1.5 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.

1.6 The main accounting issues around variable consideration are:

a) Determining what is exchanged in a contract including variable consideration (outside the scope of this discussion paper);

b) Determining whether/when to recognise a liability to transfer variable consideration;

c) How to measure a liability to transfer variable consideration;

d) How to measure goods and services acquired in exchange for variable consideration.

1.7 These issues are further described in the paragraphs below.

a) Determining what is exchanged in a contract including variable consideration

1.8 When accounting for variable consideration, one of the first issues that arises is what the transaction is about — that is, what is exchanged? If one entity is receiving the right to use a good, but has to pay a consideration based on the profit made by using the good, is the transaction a transfer of the good, or something else?

[*] See, for example, IFRIC Update January 2011 (contingent pricing of PPE and intangible assets); IFRIC Update March 2011 (contingent pricing of PPE and intangible assets); IFRIC Update May 2011 (contingent pricing of PPE and intangible assets); IFRIC Update March 2012 (variable concession fees); IFRIC Update May 2012 (contingent pricing of PPE and intangible assets); IFRIC Update September 2012 (contingent pricing of PPE and intangible assets); IFRIC Update November 2012 (contingent pricing of PPE and intangible assets/variable concession fees); IFRIC Update January 2013 (contingent pricing of PPE and intangible assets/variable concession fees); IFRIC Update March 2013 (variable payments for PPE and intangible assets); IFRIC Update May 2014 (benefit plans with a guaranteed return); IFRIC Update September 2015 (variable payments for PPE and intangible assets and variable concession fees); IFRIC Update November 2015 (variable payments for PPE and intangible assets and variable concession fees) and IFRIC Update March 2016 (variable payments for asset purchases – agenda decision).

1.9 When considering what is acquired, it may be that a transaction that initially seemed like the acquisition of a good or service for variable consideration is instead the acquisition of a number of goods and/or services – each for a fixed consideration. For example, a transaction may seem like the purchase of a machine for a variable consideration that depends fully on the number of widgets the entity is producing using the machine. In that case, when analysing the transaction, it may turn out to be an agreement to pay a fixed amount for each widget the entity is producing on the machine made available by the seller.

1.10 The discussion paper by the FRC *[INSERT TITLE WHEN FRC PAPER HAS BEEN FINALISED]* includes discussions on what goods and services are acquired in different types of variable consideration transactions. This issue is not considered in this Discussion Paper. This Discussion Paper thus discusses how to account for variable consideration when the good or service to be received in exchange for variable consideration has been determined.

b) Determining whether/when to recognise a liability to transfer variable consideration

1.11 When it has been established what the transaction is about — that is, what goods and services have been transferred — and it has been determined that it is a transaction involving variable consideration, the next question is then whether/when a liability to transfer variable consideration should be recognised. This involves determining whether the entity has a liability related to variable consideration, and if so, whether this liability should be recognised.

When does an entity have a liability related to variable consideration?

1.12 There are different views on whether/when an entity has a liability related to variable consideration. This appears, for example, from discussions of the IASB, the Interpretations Committee and in the manuals of big audit firms.

1.13 For example, the Basis for Conclusions accompanying IFRS 16 *Leases* (BC163 – BC169), notes that IASB members had differing views about whether variable payments linked to future performance or use of an underlying asset meet the definition of a liability. Similarly, when discussing the accounting for variable payments for the purchases of PPE and intangible assets outside of a business combination, the Interpretations Committee could not reach a consensus on whether the variable payments that depend on the purchaser's future activity would meet the definition of a liability for the purchaser, until the activity occur.

1.14 The Interpretation Committee was accordingly also not able to address how to account for variable contractual payments that are to be made by an operator to a grantor under a service concession arrangement accounted for under the intangible asset model within the scope of IFRIC 12 *Service Concession Arrangements*. The Interpretations Committee noted that it had previously decided that the accounting for variable payments for asset purchases was too broad an issue for the Interpretations Committee to address as also the IASB members had differing views about whether variable payments linked to an entity's future activities would be a present obligation.

1.15 While auditing firm guidance generally support recognition of variable consideration as a liability, some firms highlight that in some cases the variable consideration does not meet the definition of a liability. For example, some auditing firms argue that revenue-based variable payments[†] are not a present obligation and therefore do not meet the definition of a liability.

When should a liability related to variable consideration be recognised?

1.16 Current standards include different guidance on when a liability related to variable consideration should be recognised. For example, in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a present obligation for which a reliable estimate of the amount can be made is only recognised if it is probable (i.e. more likely than not) that an outflow of resourced embodying economic benefits will be required to settle the obligation. IFRS 9 *Financial Instruments* does not include such a threshold.

1.17 Under IFRS 16 variable lease payments are not recognised unless they are linked to a rate or index. While some IASB members argue that the reason for this is that those payments would not meet the definition of a liability (see paragraph 1.13 above), others consider that variable lease payments are not recognised for practical reasons (that is, a recognition restriction has been introduced).

c) How to measure, initially and subsequently, a liability to transfer variable consideration

1.18 Current guidance on how to address the variability from variable consideration in measurement is dissimilar. For example, in the IASB's Exposure Draft: *Regulatory Assets and Regulatory Liabilities*, variable consideration is, similar to in IFRS 15 (for revenue), 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. Under IAS 37, the measurement should be based on the best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. Also, the measurement of one liability under IAS 37 could depend on the number of similar liabilities the entity has. IAS 37 thus states that when the provision being measured involves a large population of items, the obligation is measured at expected value (that is by weighting all possible outcomes by their associated probabilities). When a single obligation is being measured, the individual most likely outcome may be the best estimate. However, when other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.

1.19 Under IFRS 9, a liability to transfer variable consideration would initially be measured at fair value and subsequently either at amortised cost or fair value. Contingent consideration under IFRS 3 *Business Combinations* would be measured at fair value independently of the type of variability and the assets used to settle the liability.

1.20 Should a service received be from an employee and might the employee then be entitled to a bonus, IAS 19 *Employee Benefits* would apply. IAS 19 does not include specific guidance on how the liability to pay the bonus should be calculated. However, an entity can only recognise the liability when the liability can be reliably estimated.

[†] Revenue-based variable consideration is, for example, used in business combinations. The acquirer may, for example, have to pay an additional amount if the revenue of an acquired entity exceeds a certain level. Although business combinations are excluded from this Discussion Paper, the interpretation could also be relevant when considering variable consideration for the acquisition of (other) goods or services.

d) How to measure goods and services acquired in exchange for variable consideration

1.21 As current guidance is dissimilar on how to reflect variable consideration in the measurement of the liability, the manner variable consideration will be reflected in the measurement of an acquired good or service will depend on the type of payment being made (unless the acquired good or service will be measured independently of the liability).

1.22 Current guidance is incomplete and dissimilar on whether changes in the measurement of a liability to transfer variable consideration should be reflected in the measurement of the acquired good or service. This also applies for the guidance included in big audit firms' accounting manuals.

1.23 When a liability for variable consideration is measured in accordance with IFRS 9 at either fair value or amortised cost, subsequent changes in the estimate of variable consideration is included in profit or loss. That is, the measurement of the acquired good or service is not updated.

1.24 Conversely, IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* states that the effect of changes in the measurement of existing decommissioning, restoration and similar liabilities should be added to, or deducted from, the related asset if the related asset is measured at cost. If the related asset is measured using the revaluation model (i) a decrease in the liability shall be recognised in other comprehensive income and increase the revaluation surplus within equity, except that it shall be recognised in profit or loss to the extent that it reverses a revaluation deficit on the asset that was previously recognised in profit or loss; (ii) an increase in the liability shall be recognised in profit or loss, except that it shall be recognised in other comprehensive income and reduce the revaluation surplus within equity to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

1.25 It could be argued, that an entity would normally not acquire an asset by taking over a decommissioning, restoration or similar liability. However, this could happen. In addition, as it appears below, IFRIC 1 is sometimes applied by analogy for other transactions by some auditing firms under the IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* hierarchy.

1.26 IFRS 3 distinguishes between:

a) Fair value changes of contingent consideration resulting from additional information that the acquirer obtains after the date of the acquisition about facts and circumstances that existed at the acquisition date. For a period not exceeding one year from the acquisition date, such changes shall retrospectively adjust the amounts recognised at the acquisition date to reflect the new information obtained.

b) Fair value changes resulting from events after the acquisition date (such as meeting an earnings target or reaching a milestone on a research and development project. Such changes shall be reflected in profit or loss (unless the contingent consideration is classified as equity – in which case the subsequent settlement shall be accounted for within equity).

1.27 As mentioned above, some auditing firms argue that variable payments in exchange for a good or service that would depend on the revenue of the acquirer does not meet the definition of a liability. Accordingly, an auditing firm believes that if the variable payments are based on future revenues, then the cost of an acquired intangible asset should be determined on the basis of the agreed minimum payments. The audit firm thinks that any additional payments should be expensed in profit or loss as the related sales occur.

1.28 However, another auditing firm acknowledges that in practice there are two general approaches when accounting for contingent consideration related to intangible assets.

> One includes the fair value of all contingent payments in the initial measurement of the assets. The other excludes executory payments from initial measurement. Under both approaches, contingent payments are either capitalised when incurred if they meet the definition of an asset, or expensed as incurred.

1.29 This auditing firm also highlights that the issue of contingent consideration has been considered by the IFRS Interpretations Committee, which separated cost into two types according to whether or not they depend on the buyer's future activity. The Committee proposed that the fair value of contingent payments that do not depend on the purchaser's future activity should be included in the initial measurement of the asset.

1.30 The auditing firm believes that a financial liability relating to variable consideration arises on the purchase of an item of PPE and any measurement changes to that liability should [generally] be recorded in the statement of profit or loss as required by IFRS 9 *Financial Instruments*. However, it notes that in some instances contracts are more complex and it can be argued that the subsequent changes to the initial estimate of the purchase price should be capitalised as part of the asset value, similar to any changes in a decommissioning liability recorded under IFRIC 1. The audit firm suggests that an entity should develop an accounting policy for variable consideration relating to the purchase of PPE in accordance with hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* based on what results in information that is relevant and reliable in its particular circumstances.

Scope and objective of this Discussion Paper

1.31 The focus of the Discussion Paper is the accounting issues from the perspective of the entity that will have to pay a variable consideration.

1.32 The Discussion Paper is not limited to variable consideration (to be) paid in cash. It thus also covers situations under which an entity will have to transfer another (non-cash) type of asset(s) or economic benefits – including providing a service – in the exchange. This means that although the Discussion Paper focuses on the entity that has to provide a variable consideration, the related obligation could be a performance obligation under IFRS 15.

1.33 The discussions on how to account for an obligation to transfer variable consideration are not limited to transactions under which 'the buyer' will receive a good or a service that is measured at cost at initial recognition and subsequently. However, the discussions on how to measure a good or service acquired for variable consideration only applies to goods and services that are measured at cost initially and subsequently.

1.34 The Discussion Paper only considers transactions that are carried out on market terms.

1.35 Variable consideration related to the acquisition of a business is outside the scope of this Discussion Paper. This is because of the special issue of allocating changes in variable consideration to the assets acquired. However, some of the guidance included in IFRS 3 is considered when developing proposals and alternatives for how to account for variable consideration.

Definition of variable consideration

1.36 The Discussion Paper considers that a consideration is variable when the acquirer of a good or service may have to transfer additional assets in exchange for the goods or services. This definition is based on the definition of contingent consideration included in IFRS 3.

1.37 The consideration to be exchanged would not have to be an amount in the functional currency of the entity but can be any type of asset of the entity (including a service it will provide). When the consideration to be exchanged for a good or service is not the functional currency of the entity, the consideration is only considered to be variable to the extent the quantity of assets to be provided is not equal to a given amount/number. Accordingly, when considering whether consideration would be variable, it is not considered whether the value of the assets an entity would have to transfer in exchange for a good or service could change. It is only considered whether the quantity of assets the entity would have to transfer could increase.

1.38 Whether the acquirer will have to transfer additional assets depends on one or several factors for which the outcome is not known at the time the good or service is acquired. The factors can both be within or outside the control of the entity that is acquiring the goods or services and is obliged to pay the consideration.

1.39 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.

1.40 Often the fact that the consideration is determined later than the time the good or service is acquired means that the transfer of the consideration will also happen later than the time of the acquisition of the good or service. However, this will not always be the case. Variable consideration would, for example, also exist in the situation when an entity will receive a discount based on the total purchase in a given year. In that case, an entity could transfer a consideration before or when the good or service is acquired. However, a refund will be received subsequently (or the amount of the refund will be subtracted future invoices of the seller).

1.41 In this Discussion Paper contingent consideration is considered to be a subset of variable consideration. Accordingly, when this Discussion Paper refers to “variable consideration” it includes contingent consideration.

1.42 The definition means that the following considerations to be provided in return for a specified item would be considered to be fixed and would thus not be covered by the definition of variable consideration in Discussion Paper:

a) A fixed amount in a foreign currency;

b) A fixed quantity of a specified item (goods or services).

1.43 Although the focus of Discussion Paper is on variable consideration, a chapter (Chapter 5) will discuss changes in the value of assets (e.g., those listed in a) and b) of paragraph 1.42) to be transferred in exchange for a good or service.

Issues considered

1.44 This Discussion Paper considers the issues related to b), c) and d) in paragraph 1.6. That is:

a) When/whether to recognise a liability for variable consideration (Chapter 2);

b) How to measure a liability related to variable consideration (Chapter 3);

c) Whether/how to reflect variable consideration in the measurement of the good or service acquired (Chapter 4).

1.45 In addition Chapter 5 considers changes in the value of the assets to be transferred in exchange for a good or service.

CHAPTER 2: RECOGNITION OF A LIABILITY FOR VARIABLE CONSIDERATION

This chapter considers whether a buyer should recognise a liability in relation to variable consideration by discussing when the definition of a liability would be met and when a liability should be recognised.

First, it is discussed what should be the unit of account when assessing whether a liability is met and when applying any recognition criteria. The chapter considers guidance in current IFRS standards on the unit of account and guidance in the Conceptual Framework. Based on this, it is proposed that:

- *The unit of account to be considered for the assessment of the definition of a liability should be each economic resource (e.g. each unit of currency) the entity might have to transfer;*

- *For recognition, variable parts of consideration should be considered as separate unit of accounts and thus not be included in a unit of account also including a fixed consideration.*

It is then considered when a liability exists in relation to variable consideration. Current guidance is dissimilar on whether a liability exists for variable consideration that depends on the acquirer's future activity. Based on the proposed unit of account for the assessment (each economic resource the entity might have to transfer) and the guidance in the Conceptual Framework, it is proposed that a liability for variable consideration that would depend on a future action the entity may or may not take would only exist if the entity has no practical ability to avoid taking that action.

Finally, it is suggested to be decided when liabilities for variable consideration should be recognised. It is considered that two approaches should be considered further:

- *Approach 1 – no recognition threshold: an entity should recognise all liabilities for variable consideration;*

- *Approach 2 – recognition threshold: an entity should recognise a liability for variable consideration only if it is probable that an outflow of economic resources embodying economic benefits will be required to settle the obligation.*

Recognition issues

2.1 This Discussion Paper considers that a liability to pay variable consideration should be recognised to the extent:

a) The definition of a liability in the IASB's *Conceptual Framework for Financial Reporting* ('the Conceptual Framework') is met*;* and

b) Recognition criteria, if any, are met.

2.2 When the definition of a liability would be met and when a liability would be recognised following any recognition criteria could depend on the unit of account considered.

2.3 This chapter accordingly considers:

a) What unit of account should be considered when assessing the definition of a liability and applying recognition criteria (if any) (paragraphs 2.4 – 2.32);

b) When the definition of a liability will be met (paragraphs 2.33 – 2.44);

c) Whether a liability to pay variable consideration should only be recognised if certain recognition criteria are met, and if so, what these criteria should be (paragraphs 2.46 – 2.87).

The unit of account for assessing the liability definition and for recognition

2.4 A consideration can include different elements. For example, it can include a fixed amount and some variable amounts. When this is the case, it is necessary to determine both the unit of account for assessing whether a liability exists and for recognition. This is because the definition of a liability and recognition criteria could result in a different outcome depending on how the unit of account is determined. For example, a fixed consideration could meet the definition of a liability and any recognition thresholds whereas some of the variable components, when considered in isolation, would not. If the variable component and the fixed component are considered as one unit of account, however, the entire consideration could meet the definition of a liability and any recognition criteria and the reflection of the variability of the entire liability would become a measurement issue.

2.5 In this Discussion Paper, a fixed part is considered to be the minimum amount of assets an entity would have to transfer. A variable part can thus only be additional assets an entity would have to transfer in exchange for a good or service.

2.6 The following sections first consider current guidance in IFRS Standards on the unit of account. It shows that current standards include different guidance on the unit of account for recognition (and measurement). Subsequently, the guidance included in the Conceptual Framework is summaries and finally, this Discussion Paper presents a proposal for how the unit of account should be set for assessing whether a liability exists and for recognition respectively.

Current guidance on the unit of account in IFRS Standards

2.7 The existing standards (including their basis for conclusions) that are relevant in this regard do normally not explicitly specify the unit of account for recognition and measurement although it may appear implicitly. IFRS 9 and IFRS 17 are exceptions. In the Basis for Conclusions to IFRS 17 it is specified that the unit of account to which the requirements in the standard should be applied is a group of insurance contracts. There seems to be several reasons for choosing this unit of account. Firstly, some of the reasons for generally not separating components of a contract seem to have been that it would be complex, would not provide useful information for interdependent cash flows and would be arbitrary. The reason for having a group of contract as the unit of account seems to be based on cost/benefit considerations and because amounts that would offset each other within the measurement of a group of insurance contracts would be treated differently (and hence not offset each other) if contracts were measured individually. In IFRS 9 it is specified in the Basis for Conclusions that the contract is the unit of account. In other standards, the unit of account may appear implicitly or be difficult to identify.

2.8 Under IAS 19 a pension obligation is measured (and recognised) without considering fixed and variable components separately. This also seems to be the approach for provisions in IAS 37, in the case they could consist of both a fixed element and a variable element. Also, IFRS 15 (when measuring a performance obligation) does not consider a variable component separately for recognition and measurement. Although IFRS 15, considering the revenue and asset side, notes that a consideration can include a variable amount (FRS 15 paragraph 50), it states that when this is the case, an entity shall estimate the (total) amount of consideration to which it will be entitled in exchange for transferring the promised goods or services to a customer. Accordingly, IFRS 15 does not consider the variable amount as a separate unit of account in relation to recognition and measurement, but the presence of variable amount results in the entire consideration being considered variable in relation to measurement.

2.9 On the other hand, IFRS 3 includes separate guidance for contingent consideration. Among other things, IFRS 3 states that an "acquirer shall classify an obligation to pay contingent consideration that meets the definition of a financial instrument as a financial liability or as equity on the basis of the definitions of an equity instrument and a financial liability in paragraph 11 of IAS 32 Financial Instruments: *Presentation*" (IFRS 3, paragraph 40). In IFRS 3, a contingent consideration element thus seems to be considered as a separate unit of account for both recognition and measurement.

2.10 Similarly, IFRS 16 *Leases* seems to reflect that variable lease payments that do not depend on an index or a rate should not be considered together with fixed lease payments.

2.11 As mentioned above, under IFRS 9, the unit of account is the contract. However, there is an exception for embedded derivatives. In some cases under which the variability would not be specific to a party to the contract, this could result in the contract being split into a fixed consideration part and a variable consideration part. This exception was introduced to avoid abuese. Generally, however, IFRS 9 would not split an obligation to pay a variable consideration into a fixed part and a variable part.

2.12 The summary above shows that differences exists in current guidance regarding whether variable consideration is considered as a separate unit of account in case a consideration consists of both a fixed and variable components.

Conceptual Framework guidance

2.13 Since the revision of the *Conceptual Framework for Financial Reporting* in 2018, the Conceptual framework has included a section on the unit of account. The guidance on unit of account in the Conceptual Framework states that the unit of account is the right or the group of rights, the obligation or the group of obligations, or the group of rights and obligations to which recognition criteria and measurement concepts are applied.

2.14 The guidance (paragraph 4.51 of the Conceptual Framework) states that the unit of account is selected to provide useful information, which implies that:

a) The information provided about the asset or liability and about any related income and expenses must be relevant. Treating a group of rights and obligations as a single unit of account may provide more relevant information than treating each right or obligation as a separate unit of account if, for example, those rights and obligations:

(i) Cannot be or are unlikely to be the subject of separate transactions;

(ii) Cannot or are unlikely to expire in different patterns;

(iii) Have similar economic characteristics and risks and hence are likely to have similar implications for the prospects for future net cash inflows to the entity or net cash outflows from the entity; or

(iv) Are used together in the business activities conducted by an entity to produce cash flows and are measured by reference to estimates of their interdependent future cash flows;

b) The information provided about the asset or liability and about any related income and expenses must faithfully represent the substance of the transaction or other event from which they have arisen. Therefore, it may be necessary to treat rights or obligation arising from different sources as a single unit of account, or to separate the rights or obligation arising from a single source. Equally, to provide a faithful representation of unrelated rights and obligations, it may be necessary to recognise and measure them separately.

2.15 The guidance also states that the unit of account should be selected so that the benefits would exceed the costs.

2.16 As the specific guidance on the unit of account only relates to the application of recognition criteria and measurement concepts, the guidance does not appear to relate to the unit of account to be applied when assessing whether the definition of a liability (or obligation) is met. For this, the definition of a liability must thus be considered.

Proposal for the unit of account

2.17 This section presents a proposal for how to set the unit of account:

a) when assessing whether the definition of a liability is met;

b) when considering recognition criteria for liabilities for variable consideration.

Unit of account for the assessment of the definition of a liability

2.18 According to the Conceptual Framework, a liability is a present obligation of the entity to transfer an economic resource as a result of past events.

2.19 It appears from the definition that there is a liability for each obligation to transfer an economic resource. This could be interpreted as meaning that there is a separate liability for each economic resource that should be transferred.

2.20 According to the Conceptual Framework, an economic resource is a right that has the potential to produce economic benefits. As, for example, each unit of currency would be an economic resource, the Conceptual Framework could be interpreted as requiring that the liability assessment should be performed for each economic resource (e.g. each unit of currency) the entity might have to transfer.

2.21 This Discussion Paper accordingly proposes that **the unit of account to be considered for the assessment of the definition of a liability should be each economic resource (e.g. each unit of currency) the entity might have to transfer**.

Unit of account to which any recognition criteria should be applied

2.22 For the issue of variable consideration, some parts of the guidance included in paragraph 2.14 above seem relevant. Particularly relevant could be the guidance stating that treating a group of rights and obligations as a single unit of account may provide more relevant information than treating each right or obligation as a separate unit of account if those rights and obligations:

a) Cannot be or are unlikely to be the subject of separate **transactions**;

b) Have similar economic **characteristics and risks** and hence are likely to have similar implications for the prospects for future net cash inflows to the entity or net cash outflows from the entity.

2.23 In the case of variable consideration the obligations all result from the same **transaction**. However, the obligations have different **characteristics and risks** and do not have similar implications for the future cash flows. If a consideration consists of both a fixed component and a variable component, there is no uncertainty related to whether the obligation that is fixed, is to be settled. On the other hand, there is uncertainty related to whether the liability related to variable component is to be settled. In addition, if there are several variable components, the type of uncertainty for each of these components could be different.

2.24 Based on the guidance included in paragraph 4.51 of the Conceptual Framework, it could thus be argued that **any fixed component and the various variable components should all be considered as separate units of account for the purpose of recognising a liability for variable consideration**.

2.25 In addition to being consistent with the guidance in paragraph 4.51 of the Conceptual Framework, this Discussion Paper also argues that it would result in the most relevant and comparable information to consider the unit of account as described in paragraph 2.24. This is because such an approach would result in the same liabilities being recognised as would be recognised if a consideration would be either fully fixed or fully variable.

2.26 Consider two types of consideration:

a) A consideration that is completely variable;

b) A consideration consisting of a fixed consideration of EUR 1 and a variable consideration similar to the consideration in the first example.

2.27 Then consider also that a liability is only recognised if it is probable that an outflow of resources embodying economic benefits will be required to settle the liability. Finally, consider the scenario that it is currently not probable that an outflow of resources related to the variable (part of the) consideration will be required to settle the liability.

2.28 Under that scenario, the consideration that is completely variable will not be recognised. Whether the consideration consisting of both a fixed and a variable part would be recognised would depend on how the unit is determined for assessing whether it is probable that an outflow of resources will be required to settle the liability.

2.29 If the unit of account is the total consideration (i.e. both the variable and the fixed consideration of EUR 1), a liability for both the fixed and variable consideration is recognised, as it is probable that resources embodying economic benefits will be required to settle the liability;

2.30 If the fixed consideration and the variable consideration are considered as separate units of account, only the liability for the EUR 1 is recognised.

2.31 The two examples in paragraph 2.26 are economically similar (assuming that the EUR 1 is insignificant compared with the amount that could be paid under the variable consideration). Accordingly, if it is assumed not to result in the most relevant information to recognise a liability for the variable consideration in the example in paragraph 2.26a) (for example, because it is not probable that resources will be required to settle the liability), the view of this Discussion Paper is that it would also not result in the most relevant information to recognise the variable part in the example in paragraph 2.26b). In addition, this Discussion Paper expresses the view that it would also not result in comparable information not to recognise a liability for the variable consideration in the example paragraph 2.26a), but to do it in the example in paragraph 2.26b).

2.32 Also for these reasons, the Discussion Paper proposes that for recognition, variable parts of consideration should be considered as separate unit of accounts and thus not be included in a unit of account also including a fixed consideration.

When does variable consideration meet the definition of a liability?

2.33 A key issue in determining whether a liability for variable consideration exists and meets the definition of a liability is whether variable consideration that depends on the acquirer's future activity, is a liability. This section first considers what guidance is included in current IFRS Standards on this, then it considers the guidance of the Conceptual Framework. Finally, this section includes a proposal for when a liability for variable consideration exists.

Current guidance in IFRS Standards

2.34 Current guidance is dissimilar on the issue of whether variable consideration that depends on the acquirer's future activity is a liability. For example, IAS 37, as interpreted in IFRIC 21 *Levies*, requires that for a liability to exist, the entity must have ability to avoid the future transfer. In cases where the transfer would depend on the purchaser's future activity, there would therefore generally not be a liability under IAS 37.

2.35 On the other hand, for post-employment benefits under a defined benefit plan, IAS 19 requires that a liability is recognised for service already provided by the an employee even if the benefits are conditional on future employment (and the employer can fire the employee to avoid paying anything).

Conceptual Framework guidance

2.36 Since IAS 19 and IAS 37 were developed, the guidance on the liability in the *Conceptual Framework* has been enhanced. This may result in more consistent guidance in the future.

2.37 The *Conceptual Framework* defines a liability as a present obligation of the entity to transfer an economic resource as a result of past events. It informs (paragraph 4.27) that for a liability to exist, three criteria must all be satisfied:

a) the entity has an obligation;

b) the obligation is to transfer an economic resource; and

c) the obligation is a present obligation that exists as a result of past events.

2.38 The supporting guidance in *Conceptual Framework* explains that an obligation is a duty or responsibility that an entity has no practical ability to avoid.

2.39 To satisfy the second criterion, the obligation must have the potential to require the entity to transfer an economic resource to another party (or parties).

a) For that potential to exist, it does not need to be certain, or even likely, that the entity will be required to transfer an economic resource—the transfer may, for example, be required only if a specified uncertain future event occurs. It is only **necessary that the obligation already exists** and that, in at least one circumstance, it would require the entity to transfer an economic.

b) The *Conceptual Framework* (paragraph 4.38) informs that an obligation can meet the definition of a liability even if the probability of a transfer of an economic resource is low. Nevertheless, that low probability might affect decisions about what information to provide about the liability and how to provide that information, including decisions about whether the liability is recognised.

2.40 Regarding the third criterion, the *Conceptual Framework* informs that a present obligation exists as a result of past events only if:

a) The entity has already obtained economic benefits or taken an action; and

b) As a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer. Under the supporting guidance, present obligation can exist even if a transfer of economic resources cannot be enforced until some point in the future. For example, a contractual liability to pay cash may exist now even if the contract does not require a payment until a future date (paragraph 4.46 of the *Conceptual Framework*).

Proposal on when a liability for variable consideration exists

2.41 As explained in the *Conceptual Framework* a liability can exist even if there is outcome uncertainty on the amount of the economic benefits it needs to transfer – it does not need to be certain that the transfer of economic benefits will take place. Variable consideration can thus meet the definition of a liability.

2.42 In relation to the question on whether a liability exists for variable consideration that depends on the acquirer's future activity, this Discussion Paper, proposes to use the guidance included in the Conceptual Framework in combination with the proposed unit of account (see paragraph 2.21 above). This means that **when variable consideration is conditional on a particular future action that the entity itself may take, a liability only exists if the entity has no practical ability to avoid taking that action.**

2.43 Therefore, a liability would not exist if, for example, payment of an amount would depend on the entity making use of a good or service received, unless:

a) The entity has started using the good or service; or

b) The good or service is essential for the entity, or not using the good or service would have economic consequences significantly more adverse than the cost to be incurred by using the good or service.

2.44 It should also be noted that a liability only exists when the entity has already obtained economic benefits or taken an action. For example, if the entity has already **obtained the acquired goods or services**.

2.45 In relation to variable consideration, an obligation would often be established by contract and thus be legally enforceable by the party to whom it is owed. However, the obligation could also be a "constructive obligation".

When should a liability for variable consideration be recognised?

2.46 When a liability for variable consideration exists, an entity will need to determine when to recognise this liability. As noted above, when discussing the unit of account, this Discussion Paper proposes that a variable part of a consideration including a fixed part, or other variable parts, should be considered a separate unit of account. The following discussion accordingly only applies to a fully variable consideration.

2.47 **The issue is on which date an entity should recognise a liability for variable consideration – at the transaction date or a later period (for example when the variability is resolved)?** The transaction date is the date the buyer enters into a contractual arrangement with another party (the seller) to acquire goods or services and that contractual arrangement is not considered an executory contract[‡].

Current guidance in IFRS standards

2.48 One of the challenges for IFRS reporting preparers, auditors and standard setters is the conflicting recognition requirements in existing IFRS Standards for variable consideration, without clearly explaining the reasons for these different treatments.

2.49 IAS 37 addresses existence and measurement uncertainty and sets out a recognition threshold for provisions and contingent liabilities. A provision is recognised when an entity has a present obligation (**more likely than not a present obligation exists**) as a result of a past event, **it is probable** (more than 50%) that an outflow of resources embodying economic benefits will be required to settle the obligation; and a **reliable estimate can be made**.

2.50 When a liability for variable consideration meets the definition of a financial liability under IAS 32 it is recognised under IFRS 9 at fair value. IFRS 9 does not specifically address how to account for variability. This would be considered when determining the fair value of the financial liability when applying IFRS 13.

2.51 In a business combination, IFRS 3 requires an acquirer to recognise the acquisition-date the fair value of contingent consideration as part of the consideration transferred in exchange for the acquired business. If the contingent consideration meets the definition of a financial liability, it is accounted for under IFRS 9 and measured at fair value. IFRS 3 essentially requires all contingent consideration to be recognised even if it is not deemed to be probable of payment at the date of the acquisition.

2.52 Both IFRS 16 and IFRS 15 specifically address the accounting for variable consideration when applied to recognition of a lease liability and revenue recognition respectively. However, the guidance in both these Standards is quite different to the requirements in IFRS 3 which requires all contingent consideration to be recognised at the transaction date.

IFRS 16

2.53 IFRS 16 requires variable payments that are deemed to be in-substance lease payments to be included in the lease liability and recognised at commencement date. Similarly, variable lease payments that depend on an index or rate - for example changes in a benchmark interest rate or a consumer price index – are also included in the lease liability at the commencement date.

[‡] An executory contract is a contract, or a portion of a contract, that is equally unperformed—neither party has fulfilled any of its obligations, or both parties have partially fulfilled their obligations to an equal extent.

2.54 All other variable lease payments are recognised in profit or loss **in the period in which the event or condition that triggers those payments occurs.** In other words, they are not recognised at the commencement date of the lease.

2.55 When developing IFRS 16 (BC164), the IASB noted that variable lease payments that are in-substance fixed lease payments are payments that, despite their variability, are unavoidable and, thus, are economically indistinguishable from fixed lease payments. For similar reasons (BC165) the IASB decided to include variable lease payments that depend on an index or a rate in the measurement of lease liabilities. **The IASB considered that those payments meet the definition of liabilities of the lessee because they are unavoidable and do not depend on any future activity of the lessee.** Any uncertainty relates to the measurement of that liability and not to its existence.

IFRS 15

2.56 The amount of revenue an entity earns can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

2.57 IFRS requires an entity to recognise revenue only to the extent that it is **highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur** when the uncertainty associated with the right of return is subsequently resolved.

2.58 IFRS 15 (paragraph 57) lists the following as possible factors that could increase the likelihood or the magnitude of a revenue reversal:

a) the amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgement or actions of third parties, weather conditions and a high risk of obsolescence of the promised good or service.

b) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

c) the entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.

d) the contract has a large number and broad range of possible consideration amounts.

2.59 When the entity determines that it cannot recognise all of the consideration received as revenue for the sale of goods with a right of return, the entity would recognise some of the consideration received as a refund liability.

2.60 The basis for conclusions (BC203) informs that the IASB concluded that information to users of financial statements would not be useful if the estimate of variable consideration (and consequently the amount of revenue recognised) is too uncertain and, therefore, may not faithfully depict the consideration to which the entity will be entitled in exchange for the goods or services transferred to the customer. In that case, an entity should not include the estimate of variable consideration in the transaction price.

2.61 The IASB conclusion responded to concerns from respondents to the Exposure Draft on revenue recognition that agreed that it was necessary to include some form of constraint on the recognition of revenue that results from variable consideration because a significant portion of errors in financial statements under previous revenue recognition requirements related to the overstatement or premature recognition of revenue. The IASB also noted that users of financial statements indicated that revenue is more relevant if it is not expected to be subject to significant future reversals.

IASB project on regulator assets and regulatory liabilities

2.62 In January 2021, the IASB published an Exposure Draft on the accounting for regulatory assets and regulatory liabilities. IASB has tentatively decided that an entity must:

a) recognise all its regulatory assets and regulatory liabilities; and

b) if the entity is uncertain whether a **regulatory asset or regulatory liability exists**, it would recognise that regulatory asset or regulatory liability " if it is more likely than not'' that it exists.

2.63 The IASB noted that there is generally little uncertainty about whether regulatory assets and regulatory liabilities exist, and therefore all regulatory assets and liabilities must be recognised. However it acknowledged that there could be cases when existence of the regulatory asset or regulatory liability might be uncertain in which case an entity would take this uncertainty into account when considering recognition.

2.64 The Exposure Draft provides guidance to help an entity determine whether a regulatory liability (or regulatory asset) exists and thus meets the definition of a regulatory liability (asset). The guidance informs that an entity needs to apply judgement considering all relevant facts and circumstances, including confirmation by the regulator of regulatory amounts, explicit requirements in the regulatory agreement, past regulatory decisions and past practices of recovery (payment), the entity's experience with the interpretations taken by the regulator and advice taken from legal and other advisors.

2.65 Some have questioned why the IASB decided to introduce a recognition threshold in view that the IASB consider that there is generally little uncertainty with regards to existence of the regulatory assets and regulatory liabilities. However, they have accepted that there could be cases where uncertainty prevails and therefore having a recognition threshold is helpful to avoid recognising assets and liabilities that do not exist and would not meet the definition of an asset or a liability under the *Conceptual Framework*.

Differences ad common themes under existing IFRS guidance on recognition of variable consideration

2.66 As discussed above, there is notable variation in existing IFRS Standards on the recognition of variable consideration. In cases where the variable payments meet the definition of a financial liability under IFRS 9, the variability will be factored in the fair value and recognised on that basis.

2.67 However, a common theme in the recognition guidance relates to the uncertainty in measuring the amount of variable consideration and the view that uncertain amounts will not provide users of financial statements with useful information.

Conceptual Framework guidance

2.68 The *Conceptual Framework* specifies that a liability is recognised only if recognition of the liability and any resulting income, expense or changes in equity provides users of financial statements with information that is useful. That is with:

a) relevant information about the liability and about any resulting income, expense or changes in equity; and

b) a faithful representation of the liability and any resulting income, expenses or changes in equity.

2.69 In relation to relevant information, the *Conceptual Framework* informs that recognition of a particular liability and if any resulting income, expense or changes in equity may not always result in relevant information when:

a) it is uncertain whether a liability exists; or

b) a liability exists, but the probability of an outflow of economic benefits is low.

2.70 Therefore, when variable consideration is subject to a high level of uncertainty, there is a question about whether and when it should be recognised.

What drives uncertainty?

2.71 This subsection considers how uncertainty would constrain the existence and therefore the recognition of variable consideration for goods or services acquired.

2.72 The level of uncertainty for a liability for variable consideration will often depend on the facts and circumstances that give rise to the variability. In some cases, these factors are related to the acquired goods or services. For example, in the retail sector variable consideration is often linked to volume of the acquired goods or services (volume discounts), in the pharmaceutical sector linked to regulatory approval and future market success of the goods or services being developed and in the real estate variable consideration is often linked to future sales/ rental income. In other cases, the amount of variable consideration could depend on factors unrelated to the acquired goods or services.

2.73 The link of uncertainty resolution with variable consideration makes it difficult to determine whether and at what point in time variable consideration should be recognised. It would therefore be helpful to have a set of principles to help an entity decide at what point it needs to recognise a liability for variable consideration.

2.74 The principles should be able to be applied to all variable consideration for goods or services acquired outside of a business combination in a consistent manner. They should also consider to what extent uncertainty should be reflected in recognition (in other words should there be a recognition threshold) or whether uncertainty should be considered only in measurement.

2.75 This Discussion Paper considers that the factors listed above are also valid for assessing uncertainty of a liability for variable consideration from a buyer's perspective where variable consideration is often linked to performance of the goods or services acquired, can take a long period to resolve and can be based on a large and broad range of possible consideration amounts.

Variable consideration linked to future activity of the underlying goods or services acquired

2.76 Variable consideration is often linked to the future performance or use of the underlying goods or services acquired. This gives the buyer the extra comfort that it only pays extra if the goods or services acquired perform as intended. However, to some extent it also gives the buyer the power to control the variable payments. For example, a buyer can avoid (partially avoid) the obligation to pay variable consideration if it decides not to use (fully use) the goods or services. As mentioned above, there are different views on whether/when a liability to such variable consideration exists.

Variable consideration linked to factors beyond the control of the buyer

2.77 In other circumstances, consideration for goods or services may depend on factors that are beyond the control of the buyer of the underlying goods or services. For example, they may depend on market conditions, market prices, interest rates or price indices.

2.78 As previously discussed, IFRS 16 considers variable payment that depend on interest rates and consumer prices indices to be treated as in-substance lease payments and included in the lease liability at the commencement date of the lease. The argument is that such payments are unavoidable and therefore meet the definition of a liability under the *Conceptual Framework.*

Alternative proposals on when a liability for variable consideration should be recognised

2.79 Based on the analysis of existing IFRS guidance that addresses variable consideration, this Discussion Paper considers that there are two main approaches that could be suggested regarding recognition of variable consideration for acquired goods or services:

a) Approach 1 – no recognition threshold: an entity should recognise all liabilities for variable consideration (similar to IFRS 9 and IFRS 3);

b) Approach 2 – recognition threshold: an entity should recognise a liability for variable consideration only if it is probable that an outflow of economic resources embodying economic benefits will be required to settle the obligation (similar to, for example, IAS 37).

2.80 The approach would be applied to a fully variable (component of a) consideration (see paragraph 2.46 above) and only to the extent that the definition of a liability is met for this (component of a) consideration (or, in case of Approach 2, when it is not clear whether the definition of a liability is met because of existence uncertainty).

Other approaches not considered in this discussion paper

2.81 The approach to recognition approaches could be based on other alternatives than those listed above.

IFRS 16 approach

2.82 For example, recognition could follow an IFRS 16 approach in which variable consideration would only be recognised when considered to be in-substance consideration or would not be linked to future performance or use **of** the goods or services until the performance or use occurs.

Regulatory liabilities approach

2.83 Another alternative would be to follow the proposed approach in the IASB Exposure Draft on the accounting for regulatory assets and regulatory liabilities that states that a regulatory liability is recognised if it is "more likely than not'' that it exists. This approach is discussed in above in paragraphs 2.62 to 2.65. This alternative would acknowledge that it is not always certain that a liability for variable consideration exists at the transaction date. This uncertainty needs to be considered in recognition. For example, in cases when the amounts for variable consideration are highly uncertain (because they could take a long time to resolve) or when the variable consideration is based on events that could reverse once the variably on these events is clarified. In some cases consideration can remain variable for longer than 5 years, making it uncertain that a liability exists at the transaction date and whether it meets the definition of a liability under the *Conceptual Framework*.

2.84 Furthermore, the existence of a liability is also questionable when variable events that determine the amount of variable consideration are based on the performance of the underlying goods or services or factors within the control of the buyer of those goods or services. Such factors can lead to the buyer avoiding payment in which case a liability would not exist. For these reasons, recognition of the liability under this alternative is subject to a recognition threshold based on existence when it is ''more likely than not''.

Never recognise a liability for variable consideration

2.85 A further approach would be never to recognise the liability for variable consideration. This alternative considers that uncertainty resolution makes it difficult to determine the amount of variable consideration until the event of the uncertainty is resolved. It responds to concerns that many consider that it is extremely difficult in many cases to estimate variable payments if the amounts depended on future sales or the use of the underlying goods or services and that such payments would be subject to existence uncertainty and a high level of measurement uncertainty. Because of the amount of judgment involved the cost of recognising variable consideration at the transaction date would outweigh the benefit for users of financial statements.

2.86 This alternative would be based mainly on cost-benefit reasons, rather than conceptual unpinning, in view that in some cases, if not all, the variable consideration would exist at the transaction date and would therefore meet the definition of a liability under the *Conceptual Framework*. However, there may be cases where the level of uncertainty in determining the existence and amounts for variable consideration would lead to the conclusion that it would not meet the definition of a liability under the Conceptual Framework.

2.87 This alternative is based mainly on cost-benefit reasons, rather than conceptual unpinning, in view that in some cases, if not all, the variable consideration would exist at the transaction date and would therefore meet the definition of a liability under the *Conceptual Framework*. However, there may be cases where the level of uncertainty in determining the existence and amounts for variable consideration would lead to the conclusion that it would not meet the definition of a liability under the Conceptual Framework.

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