# Accounting for variable consideration

## EFRAG Discussion Paper

1 June 2022 – EFRAG FR Board meeting
Paper 05-02

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# OVERVIEW

**Background and objective**

**Scope of the Discussion Paper**

**Issue 1 (Liability recognition issue- Chapter 2**): When to recognise a liability under IAS 32/IFRS 9 for variable consideration to be paid in cash (or transfer of another) and where variable consideration depends on the purchaser's future actions

**Issue 2 (Acquired asset measurement issue- Chapter 3**): Whether and when to update the cost measurement of an acquired asset for changes in estimates of variable consideration

**Chapter 4- Holistic review of requirements for accounting for variable consideration** complements the analysis of the accounting challenges in Chapters 2 and 3.

# Background and objective

# Background

The approval and inclusion of the **project in the EFRAG proactive agenda in 2018** was based on feedback to the 2018 EFRAG Research Agenda Consultation.

It was premised on the significant diversity in practice on two aspects of accounting for variable consideration by purchaser entities, namely:

- The timing in recognition of liabilities for variable consideration (**liability issue**) ;
- Whether or not to include changes in the remeasurement of liabilities for variable consideration in the cost of the acquired asset (**acquired asset measurement issue**)

The aforementioned diversity in practice was confirmed through interviews with audit firms and by the review of past IFRS Interpretations Committee discussions. (IFRS Interpretations Committee concluded that the issue was too broad.

A project on variable and contingent consideration was added to the IASB's research pipeline following the 2015 Second Agenda Consultation– but the **IASB has decided to remove this project as a result of feedback to its 2021 Third Agenda Consultation**

# Objective

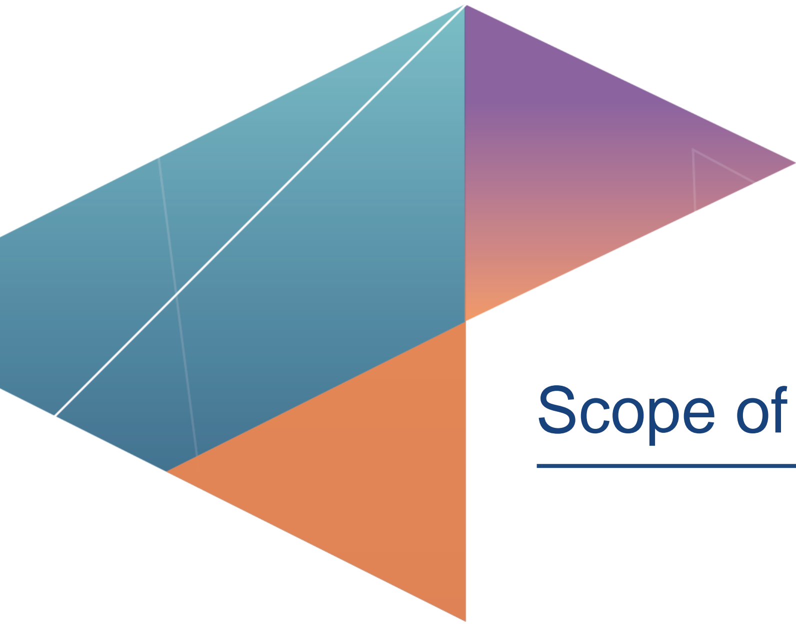
## Usefulness of EFRAG Discussion Paper

The IASB's removal of VC as a project following its Third Agenda consultation reflects relative priority based on its current resources

Accounting challenges addressed in the DP remain, and the findings and feedback to this Discussion Paper can be useful to the IASB as follows:

- The principles and proposed solutions in Chapters 2 and 3 address where diversity in practice occurs or for emergent transactions and thus **can be a reference point should the IFRS Interpretations Committee face interpretation questions or should the IASB have to make narrow scope amendments in the future**
- The Discussion Paper can be a reference point for the narrow scope amendment project for provisions on IAS 37

The question to constituents on whether or not to develop a unified set of principles after considering cost-benefit and impact on usefulness of **information can allow the validation of the merits or otherwise of the IASB's decision not to add a project on VC** to its technical agenda



# Scope of the Discussion Paper – Chapter 1

# Discussion Paper's Definition of variable consideration

## Discussion Paper's definition is based on the IFRS 3 definition

Consideration is variable **when the purchaser of a good or service may have to transfer additional assets in exchange for the good or service to the seller**.

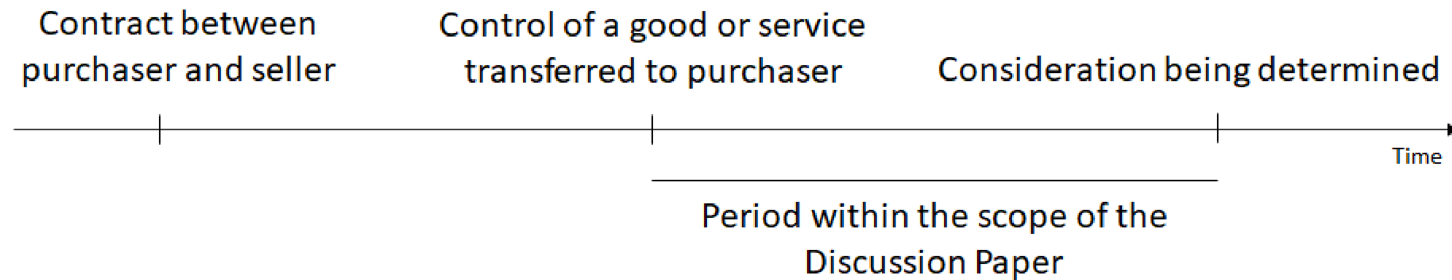
That is, a **change in the value of the assets due to changes in unit price (for example, caused by a change in a foreign currency exchange rate) is not considered to be variable consideration.**
Also, the DP does not consider payments in own shares.

**Other non-exchange transfers of assets (for example in the case of a decommissioning liability) are not considered to be variable consideration**

# Scope

## Non-executory contracts

Scenario covered by DP:




## Focus on purchaser

Discussion Paper only deals with how to account for variable consideration by the purchaser (obligor).

## Substance of transaction known

The considerations included in the Discussion Paper assumes that a transaction is for variable consideration following the definition used.

# Scope

## Issue 1 - Liability recognition issue (Chapter 2)

**When to recognise a liability under IAS 32/IFRS 9 for variable consideration to be paid in cash (another financial instruments) and where variable consideration depends on the purchaser's future actions?**

Main liability recognition challenge arises if the variability depends on the purchaser's future actions (i.e., **there is varied interpretation of IAS 32 requirements on when obligating event arises for these transactions**)

# Scope

## Issue 2 - Acquired asset measurement issue (Chapter 3)

**Whether and when to update the cost measurement of an acquired asset for changes in estimates of liabilities for variable consideration**?

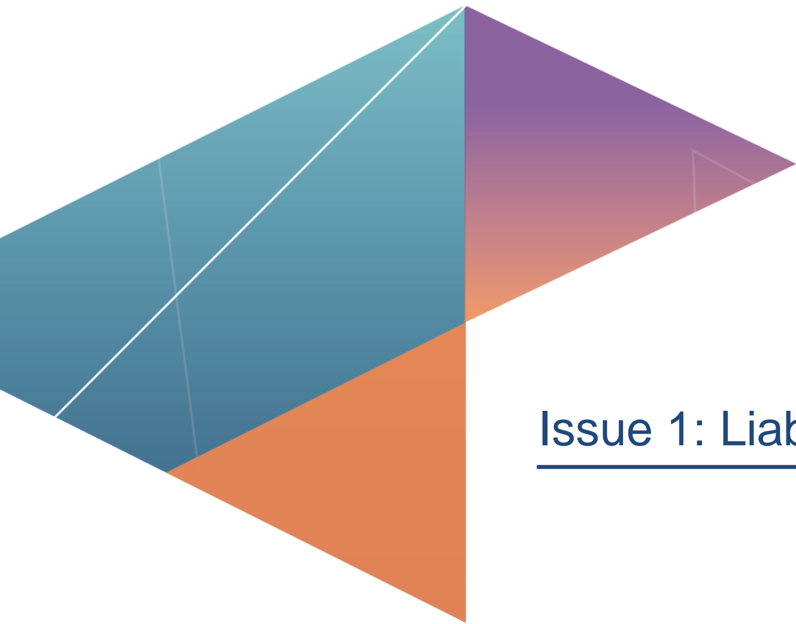
This question is **only relevant for assets measured at cost. Problem arises due to varied interpretation of cost, and conflicting guidance**

This question is not restricted to transactions where variable consideration depends on the purchaser's future actions

For simplicity and to show the interlinkage between liability and asset measurement, the focus in chapter 3 of the Discussion Paper is on the remeasurements of liabilities for variable consideration for the same transactions that are the focus of Chapter 2.

# Overview of what is in and out of Scope

| Coverage Issue | The liability recognition issue | The measurement of the acquired asset issue |
|---|---|---|
| Variable consideration to: | | |
| - the seller | ✓ | ✓ |
| - a party other than the seller | ✗ | ✗ |
| Variable consideration includes: | | |
| - transfer of additional assets | ✓ | ✓ |
| - value changes of the asset(s) to be transferred | ✗ | ✗ |
| Variable consideration depends on: | | |
| - the purchaser's future actions | ✓ | ✓ |
| - factors other than the purchaser's future actions | ✗ | ✓ |
| A liability for variable consideration would be covered by: | | |
| - IFRS 9 | ✓ | ✓ |
| - an IFRS Standard other than IFRS 9 | ✗ | ✗ |
| The acquired asset is measured initially and subsequently at: | | |
| - cost | ✓ | ✓ |
| - something else than cost | ✓ | ✗ |
| Transaction is: | | |
| - carried out on market terms | ✓ | ✓ |
| - not carried out on market terms | ✗ | ✗ |
| Consideration is: | | |
| - an asset | ✓ | ✓ |
| - own shares | ✗ | ✗ |
| Acquisition is: | | |
| - part of a business combination | ✗ | ✗ |
| - outside a business combination | ✓ | ✓ |



## Issue 1: Liability recognition - Chapter 2

# Issue 1: The liability recognition issue

## Cause of the issue: Varied interpretation of IAS 32 requirements *

| Interpretations | Reasons |
| --- | --- |
| Recognise liability when asset is received | • Purchaser does not have a right to avoid paying cash as it is a non-executory contract<br>• The purchaser's future actions is beyond the control of the purchaser since IAS 32 considers this to be the case for the purchaser's future revenues, net income or debt to equity ratio |
| Recognise a liability when event that triggers the variable payment occurs | • The event of the occurrence or non-occurrence of uncertain future events is within the control of the purchaser so recognise only when the event occurs |
| Recognise an equity component (instead of a liability) | • No financial liability exists when asset is received, therefore a residual exists, ie an equity component |

* Based on paragraphs 19 'unconditional right to avoid' and 25 of IAS 32 'occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument'.

# Issue 1: The liability recognition issue

## Aspects considered in Chapter 2

- Definition of a liability in the Conceptual Framework for Financial Reporting.
  - The entity has an obligation
    - Arising question that impacts timing of recognition: ***when does the entity have a duty or responsibility that it has no practical ability to avoid?***
  - The obligation is to transfer an economic resource ✓
  - The obligation is a present obligation that exists as a result of a past event
    - Arising question that impacts timing of recognition: ***is the past event when the entity receives the asset or when it performs the activity that triggers the variable consideration?***

Conceptual Framework guidance interpreted differently

- Current requirements in other IFRS standards meeting the variable consideration definition

Most of the current requirements reflect that a liability is recognised when the goods or services are received. These requirements do not distinguish between whether the variability is linked to the purchaser's future actions or not

# Issue 1: The liability recognition issue

## Alternatives based on the Conceptual Framework

### Alternative 1

- Recognise a liability when asset is received and purchaser does not have a practical ability to avoid the payment

### Alternative 2

- Recognise a liability when the purchaser performs the actions that would trigger the variable consideration (considered that the purchaser has no practical ability to avoid payment at this time)

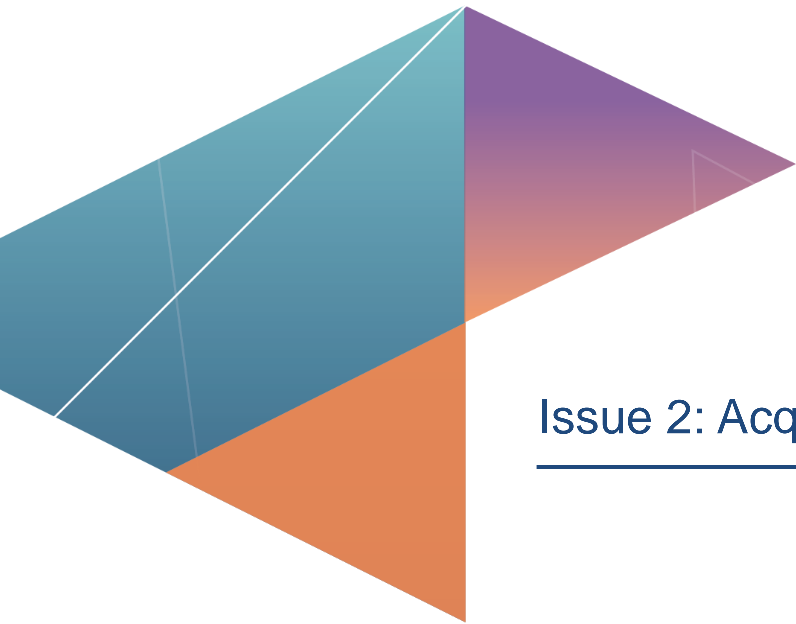
➢ DP includes advantages and disadvantages for each alternative.

# Issue 1: The liability recognition issue

## Possible criteria for no practical ability to avoid

Possible criteria for assessing when the purchaser would not have a practical ability to avoid paying the variable consideration

- Entity ceasing its activities to avoid the payments (extreme case)
- Significant unfavourable economic impact for the entity
- Significant unfavourable economic impact related to the acquired asset
- Impact linked to initial economic purpose for acquiring the asset
- Marginally economically unfavourable for the entity not to perform the activities that would trigger the variable payments (extreme case)



## Issue 2: Acquired asset measurement issue - Chapter 3

# Issue 2: The measurement of the acquired asset issue

## Cause of issue: Different interpretations on what cost means *

| Interpretations | Reasons |
| --- | --- |
| Cost of asset should be updated | • The definition of cost includes, within cost, the amount of cash or cash equivalents that would eventually be paid so encompasses all amounts expected to be paid in cash or cash equivalents |
| Cost of asset should not be updated | • The definition of 'cost' refers to specific points in time, e.g., when initial recognised so cost should not be updated for changes in the amount to be paid to acquire an asset |
| Cost of asset should be updated until asset is ready for its intended use | • Point in time at which the cost of the acquired asset can no longer be revised except for reflecting the amortisation/depreciation and impairment losses associated with the asset |

* Based on the definition of cost in IAS 16, IAS 38 and IAS 40

# Issue 2: The measurement of the acquired asset issue

## Aspects considered in Chapter 3

- Current requirements in other IFRS standards on whether the cost of an asset should be updated to reflect changes in the related liability
  - There is inconsistency across current requirements on whether cost should be updated. For example, under IFRS 9, changes in the measurement of the liability are recognised in P&L while under IAS 16, costs of dismantling and removing an item are reflected in the cost of the asset.

- Guidance on the Conceptual Framework
  - No clear guidance from guidance on historical cost

# Issue 2: The measurement of the acquired asset issue

## Alternatives proposed in the DP

### Alternative 1

- Never update cost

### Alternative 2

- Always update cost

### Alternative 3

- Update cost sometimes
- Possible criteria (multiple can be chosen):
  a) Update if liability included in original measurement
  b) Update until the asset is ready for its intended use
  c) Update if variable payments associated with future economic benefits
  d) Update if variability is linked to the initial quality of the asset

➢ DP includes advantages and disadvantages for each alternative.

# Holistic review of requirements for accounting for variable consideration- Chapter 4

# Holistic review of requirements for accounting for variable consideration

## Objective of Chapter 4

Chapter 4 provides a holistic review that complement the analysis in the two main chapters addressing areas where there are known practical problems Encompasses an analysis of requirements for transactions outside the scope of Chapters 2 and 3 and consists of an assessment of:

- Consistency (or lack thereof) of IFRS requirements for variable consideration
- Possible standard setting implications
- Matters of note outside the scope of transactions in

## Consistency (or lack thereof) of IFRS requirements for variable consideration

- Assessed requirements and any reasons provided for the requirements in the Basis for Conclusions
- Further to IAS 32 that is analysed in Chapter 2, reviewed requirements for liability recognition (IAS 19, IFRS 2, IFRS 16, IAS 37)
- Reviewed possible analogous application (IFRS 15 mirroring approach, RRA ED principles)

# Holistic review of requirements for accounting for variable consideration

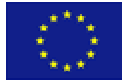
## Possible standard setting implications

Advantages and disadvantages including cost-benefit considerations and impact on usefulness of information of:

- Developing a unified set of principles that can be applied across IFRS requirements for accounting for variable consideration
- Undertaking a standard-by-standard revision of requirements (IAS 16 or IAS 38)

## Matters of note for transactions outside the scope of Chapters 2 and 3

- Addresses issues that may arise when variable consideration is paid by the transfer of a non-financial asset or by performing a service
- Notes that variable consideration based on non-cash transactions (e.g. based on exchange of crypto-assets) may become more significant
- Highlights the challenge of disentangling changes in value due to changes in unit price- which is excluded from the definition of variable consideration
- Highlights complexities in the valuation of non-financial liabilities



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