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An IFRS 15 mirroring approach for accounting for variable consideration
Issues Paper

THIS PAPER IS UNCHANGED FROM PAPER 06-04 FOR THE FEBRUARY 2022 EFRAG FR TEG MEETING

Objective

1 The Discussion Paper addresses two issues in the accounting for variable consideration by purchaser entities, namely: a) the recognition of the liability for variable consideration that is to be paid in cash (or another financial instrument), and where the variability depends on the purchaser's future actions; and b) whether changes in estimates related to variable consideration are reflected in the measurement of acquired goods or services.

2 The objective of this paper is to present an approach to account for a liability related to variable consideration by purchaser entities that is based on the requirements of IFRS 15 *Revenue from Contracts with Customers* that is applicable to seller entities (herein referred to as the IFRS 15-mirroring approach). In this session, we ask EFRAG TEG members whether such an approach should be one of the approaches considered in the Discussion Paper for the recognition of the liability for variable consideration by purchaser entities.

3 It is the assessment of the EFRAG Secretariat that IFRS 15 guidance can only be used to consider the recognition and measurement of a liability for variable consideration but not for whether changes in a liability for variable consideration should be included in the cost of the acquired asset[1].

IFRS 15 guidance

4 In relation to variable consideration, IFRS 15 states:

> 46 When (or as) a performance obligation is satisfied, an entity shall recognise as revenue the amount of the transaction price (which excludes estimates of variable consideration that are constrained in accordance with paragraphs 56–58) that is allocated to that performance obligation.
>
> …

[1] Although the IFRS 15 guidance would only be used to consider the recognition and measurement of a liability, this could also affect whether changes in estimates of a liability for variable consideration would be reflected in the cost of the acquired asset. This is because under some of the approaches considered for when to reflect the changes in variable consideration in the measurement of the asset, the measurement of the asset depends on whether a liability for the variable consideration is recognised when the asset is transferred. This would be the case if changes in estimate of variable consideration would only be included in the cost of the acquired asset to the extent the estimate of variable consideration would originally be included in the cost of the acquired asset, because a liability for variable consideration would be recognised when the asset is acquired.

53 An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

a. The expected value—the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

b. The most likely amount—the most likely amount is the single most likely amount in a range of possible consideration amounts (ie the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

…

Constraining estimates of variable consideration

56 An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 53 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 variable consideration is subsequently resolved.

57 In assessing whether it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

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 entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

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

58 An entity shall apply paragraph B63 to account for consideration in the form of a sales-based or usage-based royalty that is promised in exchange for a licence of intellectual property.

Reassessment of variable consideration

59 At the end of each reporting period, an entity shall update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity shall account for changes in the transaction price in accordance with paragraphs 87–90 [on allocating the changes to the change to the various performance obligations included in a contract].

…

B63 Notwithstanding the requirements in paragraphs 56–59, an entity shall recognise revenue for a sales-based or usage-based royalty promised in exchange for a licence of intellectual property only when (or as) the later of the following events occurs:

a. the subsequent sale or usage occurs; and

b. the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

Reasons for "special" requirements

Constraining the amount of variable consideration recognised as revenue

5 The reason why IFRS 15 is constraining variable consideration to be included in revenue (see the reference to paragraph 56 in IFRS 15 above in paragraph 4) is because users do not consider reversals of revenue figures to provide the most relevant information for estimating future revenue. Paragraph BC206 of the Basis for Conclusions accompanying IFRS 15 thus states:

> In their redeliberations, the boards [the project was a joint project of the IASB and the FASB] decided that it would be helpful to clarify the objective for constraining estimates of variable consideration. In making their decision, the boards considered the feedback received from users of financial statements. The majority of users of financial statements that were consulted indicated that the most relevant measure for revenue in a reporting period would be one that will not result in a significant reversal in a subsequent period. This is because an amount that would not reverse in the future would help users of financial statements better predict future revenues of an entity. Therefore, the boards decided that the focus for constraining revenue should be on possible downward adjustments (ie revenue reversals), rather than on all revenue adjustments (ie both downward and upward adjustments). Specifically, the boards decided that an entity should include some or all of an estimate of variable consideration in the transaction price only to the extent it is highly probable that a significant revenue reversal will not occur.

Sales-based or usage-based royalty

6 The reason why IFRS 15 includes special requirements for sales-based and usage-based royalties (see the reference to paragraph B63 in IFRS 15 above in paragraph 4) is that the IASB considered that including estimates of this amount initially would result in adjustments to the amount of revenue recognised throughout the life of the contract even though those changes would not be related to the entity's performance.

7 Paragraph BC415 of the Basis for Conclusions accompanying IFRS 15 thus states:

> The boards decided that for a licence of intellectual property for which the consideration is based on the customer's subsequent sales or usage, an entity should not recognise any revenue for the variable amounts until the uncertainty is resolved (ie when a customer's subsequent sales or usage occurs). The boards had proposed a similar requirement in the 2011 Exposure Draft because both users and preparers of financial statements indicated that it would not be useful for an entity to recognise a minimum amount of revenue for those contracts. This is because that approach would inevitably have required the entity to report, throughout the life of the contract, significant adjustments to the amount of revenue recognised at inception of the contract as a result of changes in circumstances, even though those changes in circumstances are not related to the entity's performance. The boards observed that this would not result in relevant information, particularly in contracts in which the sales-based or usage-based royalty is paid over a long period of time.

8 The IASB and the FASB considered whether to expand the scope of this special requirement to all variable consideration that depends on the customer's future actions. However, the boards rejected this as:

> […] it would have prevented an entity from recognising any revenue when the goods and services were transferred in cases in which the entity could estimate the variable consideration and meet the objective of constraining estimates of variable consideration. (BC 417)

9 The IASB and the FASB also noted that:

10 […] expanding the scope to constrain revenue when consideration is based on the customer's future actions would also have increased complexity. It would have required the

boards to create another exception to maintain the requirements for accounting for customer rights of return, which also results in consideration that is dependent on the customer's future actions. (BC418)

11 The IASB and the FASB also considered whether the restriction for a sales-based or usage-based royalty on a licence of intellectual property could be incorporated into a general principle. However, the boards rejected this approach because it would have added complexity to the model that would outweigh the benefit.

Implications of applying an 'IFRS 15-mirroring' approach

12 If an IFRS 15-mirroring approach was used to account for a commitment to pay variable consideration it would mean:

(a) To the extent that a purchaser's acquisition of a licence of intellectual property in exchange for a sales-based or usage-based royalty would meet the definition of variable consideration in this Discussion Paper, a liability for the variable consideration should only be recognised when the subsequent sale or usage occurs.

(b) In other cases (i.e., for transactions other than those related to the acquisition of licences for intellectual property in exchange for sales-based or usage-based royalties), a liability for variable consideration would be recognised when the related good or service is received by the purchaser including when the variability would depend on the purchaser's future actions. The liability might, however, initially be measured at nil as the measurement of the liability should be constrained to the amount it is highly likely will not be significantly reduced as a result of changes in the estimate of variable consideration. This is because under IFRS 15 the seller would only recognise an amount of variable consideration 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 variable consideration is subsequently resolved. Similarly, the purchaser should therefore constrain the measurement of the liability to pay variable consideration to the amount it is highly likely will not be significantly reduced.

(c) Subject to the IFRS 15 constraint mentioned above in (b), the liability of variable consideration should be measured at the expected value or most likely amount depending on which method the purchaser expects to better predict the amount of consideration it will have to pay.

(d) The purchaser shall update the estimated variable consideration (including updating its assessment of whether an estimate of variable consideration is constrained according to (b) above) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period.

IFRS Interpretations committee Previous discussion

13 When the IFRS Interpretations Committee ('IFRIC') considered variable consideration, it was similarly considered how an approach following from the revenue recognition project would work for purchasers. Some of these debates took place before IFRS 15 was issued in May 2014. The issue was thus considered by IFRIC at its May 2012 meeting (Agenda Paper 3A). After IFRS 15 was issued, IFRIC considered the IFRS 15 approach again. In a staff paper (Agenda Paper 02A) for the November 2015 IFRIC meeting it was noted:

We do not think that requiring a purchaser to apply an approach based on the probability of making the variable payments will necessarily result in symmetrical accounting outcomes with the vendor. This is because the judgement applied by the purchaser and the vendor may result in different conclusions as to the probability of the cash flows resulting from the arrangement, which could, in turn, result in a non-symmetrical accounting treatment by the two parties for the same payment. The vendor may have significant experience from similar transactions that it could consider in making its assessment. Asset purchases may be more likely to be one-off transactions for purchasers, as a result of which they may not have the benefit of similar experience in making the assessment.

We also note that while this approach was considered by the IASB in developing the leasing principles, it was not adopted by the IASB for accounting for variable payments in a lease contract. We understand that a majority of users and preparers did not favour this approach and noted that the costs would outweigh the benefits.

Our views on the advantages and disadvantages of applying an approach requiring the inclusion of payments based on a high probability threshold are summarised in the following table:

Advantages	Disadvantages
• May give a more faithful depiction of the obligations incurred by the purchaser than the leasing principles, because it may be more reflective of the expected cash flows. • Because measurement is less subjective when compared to applying the business combination principles, both the balance sheet and the profit/loss statement could result in the presentation of more reliable estimates. • May be more straightforward to apply than the business combination principles because lower probability payments are excluded.	• Judgement of probability may be highly subjective and could vary between entities for economically similar contracts. This would reduce the comparability and consistency of financial information reported. • Could lead to opportunities for structuring contracts as leases, not purchases, in order to obtain a more favourable accounting treatment. • Difference with the accounting for contingent consideration in a business combination does not result in alleviating the pressure on applying the definition of a business. • As compared to applying the business combination principles, this approach could result in a liability that is less reflective of the lessee’s contractual obligations to make payments. • May be more difficult, complex and costly to apply as compared to the leasing principles.

We think the disadvantages of this approach outweigh the advantages and do not recommend applying these principles in developing the principles for initial accounting for variable payments in an asset purchase.

Comments of the EFRAG Secretariat

Partial IFRS 15 mirroring approaches

Approach for when to recognise a liability

14 The EFRAG Secretariat considers that EFRAG’s Discussion Paper could include an additional approach to account for variable consideration that would depend on the purchaser’s future actions in Chapter 2 (and/or Chapter 4, if EFRAG TEG would decide to include that chapter) that would be based on the guidance in IFRS 15 dealing with sales-based and usage-based royalties. The guidance on sales-based and usage-based royalties could be considered in Chapter 2 as it could be argued that sales and usage of an asset would depend on the purchaser’s future actions. As noted in paragraph 14, under an IFRS 15 mirroring approach a liability for variable consideration would always be recognised when the purchaser receives the associated good or service, expect for the cases where the variable consideration is a usage-based or sales-based royalty. In the latter cases, a liability would only be recognised as the use or sales occurs. The proposed approach would, however, be modified such that a liability related to variable consideration would not be constrained to the amount it is highly likely that will not be significantly reduced as a result of changes in the estimate of variable consideration when the uncertainty associated with the variable consideration is subsequently resolved (i.e.,

the proposed approach would not analogously extend the IFRS 15 constraint applied towards the recognition of variable consideration to the recognition of the liability for variable consideration by the purchaser).

Approach for measuring a liability for variable consideration

15 If it is decided to include an additional Chapter 4 (see Paper 06-03) in the Discussion Paper, the EFRAG Secretariat also considers that an approach that is based on IFRS 15 requirements could be considered as one of the approaches for the measurement of a liability for variable consideration. Under this approach, the liability would be measured at the expected value or most likely amount depending on which method the purchaser expects to better predict the amount of consideration it will have to pay, could be considered. Again, this approach would exclude the requirement in IFRS 15 to constrain the amount so that it is highly likely that it will not be significantly reduced as a result of changes in the estimate of variable consideration when the uncertainty associated with the variable consideration is subsequently resolved (i.e., the proposed approach would not analogously extend the IFRS 15 constraint applied towards the measurement of variable consideration to the measurement of the liability for variable consideration by the purchaser).

Complete IFRS 15 mirroring approach

16 In relation to including a discussion of a 'complete IFRS 15 mirroring approach' (i.e., does not exclude the IFRS 15 measurement constraint) in Chapter 2, the EFRAG Secretariat notes that Chapter 2 only considers approaches for variable consideration to be paid in cash that would depend on the purchaser's future actions. Applying a complete IFRS 15 mirroring approach would therefore result in accounting for variable consideration that depends on the purchaser's future actions in a significantly different manner to accounting for variable consideration that does not depend on the purchaser's future actions. The EFRAG Secretariat has not found good arguments justifying only constraining the measurement of a liability for variable consideration to the amount that is highly likely not to be significantly reduced as a result of changes in the estimate of variable consideration, when the variability depends on the purchaser's future actions, but not in other cases.

17 In relation to including a discussion of a complete IFRS 15 mirroring approach in Chapter 4, the EFRAG Secretariat notes the disadvantages identified in the IFRIC paper summarised in paragraph 13 above. In addition, the EFRAG Secretariat notes that constraining the measurement of a liability for variable consideration to the amount that is highly likely not to be significantly reduced as a result of changes in the estimate of variable consideration would not be prudent.

Questions for EFRAG FR TEG

18 Does EFRAG FR TEG consider that EFRAG's Discussion Paper should include a discussion of an IFRS 15 mirroring approach? If so:

(a) Should the discussion cover a 'complete' approach as described in paragraph 12 or only a 'partial' approach / approaches where only some aspects are considered (e.g. the approaches mentioned in paragraphs 14 and 15 above)?

(b) Where should the approach(es) be considered? (In Chapter 2, in Chapter 4 should it be decided to have such an additional chapter, or in both)?