Accounting for variable consideration

EFRAG Discussion Paper and initial feedback

15 March 2023 – EFRAG FR TEG CFSS meeting

EFRAG

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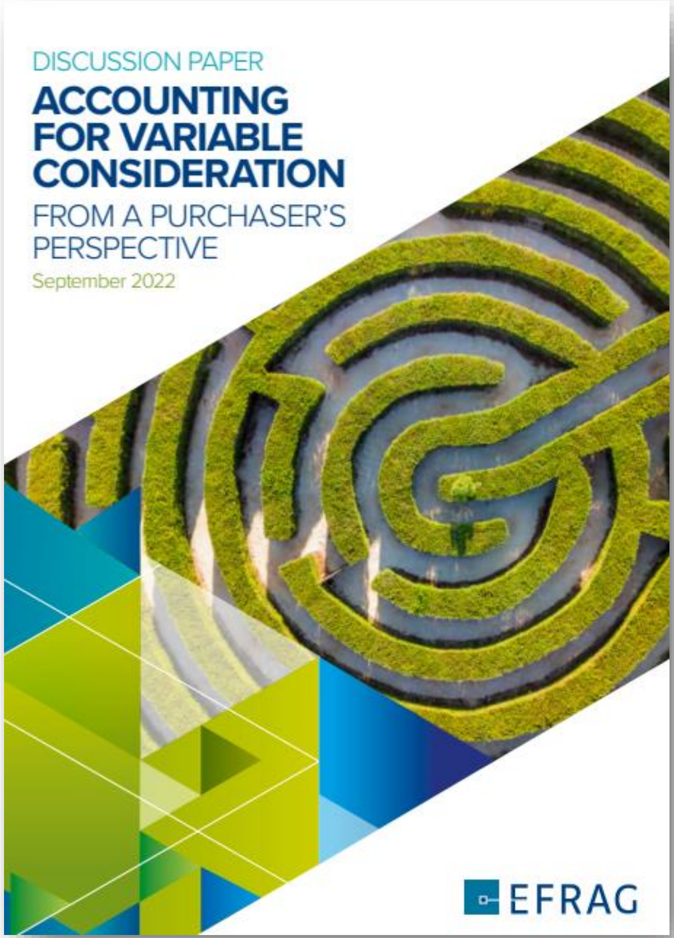
[Discussion Paper](#) open for consultation until 30 November 2023.



OVERVIEW

Background and objective

Scope of the Discussion Paper

The liability recognition issue

When to recognise a liability within the scope of IAS 32/IFRS 9 when variable consideration depends on the purchaser’s future actions.

The measurement of the acquired asset issue

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

General IFRS requirements and standard-setting implications

Whether a unified set of principles should be developed to align IFRS requirements.

Questions included in the Discussion Paper

Background, objective and scope

Background and objective

- Result of the 2018 EFRAG Research Agenda Consultation. It is an area where significant diversity in practice exists (also evidenced by IFRS Interpretation Committee discussions).

- Although a project on variable consideration has been removed from the IASB's research pipeline, the accounting challenges remain.

- The feedback to the DP may be useful for the IASB:
  - When deciding on its post 2026 workplan;
  - For a project on variable consideration after 2026;
  - Amendments to standards that would include requirements related to variable consideration. E.g., some respondents to EFRAG's DP on Better Information on Intangibles thought that variable consideration was an issue that should be addressed (in relation to intangible assets).

Issue

Initial feedback

- Significant divergence exists in practice.
- Amounts can be very significant.
- Occurs in: pharmaceutical industries, extractive industries, media and entertainment and in relation to concession arrangements.

Condensed example from an accounting manual

A football club signs a new player on a 4-year contract. In securing the registration of the new player, the football club agrees to make the following payments to the player's former club (in addition to a fixed payment to be paid some time after the transfer):

- CU 1 million as soon as the player has made 25 appearances for the club
- CU 0.2 million when the player is first selected to play for his country
- 25% of the gross proceeds from any onward sale of the player before the expiry of the initial contract term.

(The example is based on Illustration 4-2 Contingent consideration relating to a football player's registration in Chapter 17 of EY's International GAAP 2023).

DP's definition of variable consideration

Consideration is variable when the purchaser of a good or service may have to transfer **additional assets** 1 in exchange for the good or service to **the seller**. 2 3

1 Changes 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.

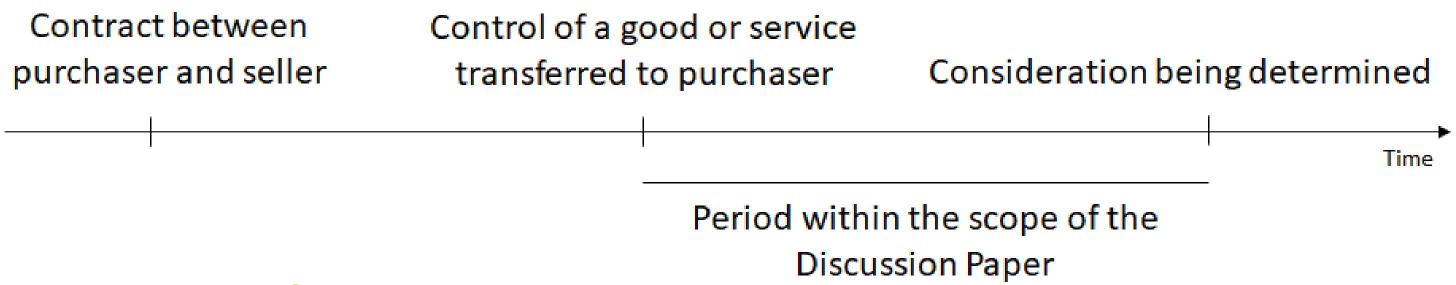
2 Uncertain transfers to third parties (for example in the case of a decommissioning liability) are not considered to be variable consideration.

3 Based on the definition of contingent consideration included in IFRS 3 *Business Combinations*.

Scope

Non-executory contracts

Scenario covered by the DP:



Focus on purchaser

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

Substance of transaction known

The DP assumes that a transaction is for variable consideration following the definition used and (therefore) that the variable consideration is for rights/assets already received.

Scope

Liability recognition issue

When to recognise a liability within the scope of IAS 32/IFRS 9 for variable consideration **that depends on the purchaser’s future actions**.

Measurement of the acquired asset issue

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

- Also variable consideration that does not depend on the purchaser’s future actions.
- To simplify the DP the only changes in liabilities covered by IAS 32/IFRS 9 are covered.

The liability recognition issue

The liability recognition issue

One cause of the issue

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. • The purchaser's future action 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 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.

The liability recognition issue

Basing requirements on the definition of a liability in the Conceptual Framework for Financial Reporting

- Definition of a liability in the Conceptual Framework:
  - The entity has an obligation.
    - 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.
    - When is the relevant past event? (When the entity receives the asset or when it performs the activity that triggers the variable consideration)?

Conceptual Framework guidance interpreted differently

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

The liability recognition issue

Alternatives based on the Conceptual Framework

Alternative 1

- Recognise a liability when the 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).

The liability recognition issue

Qualitative characteristics of useful information for the Alternatives considered

- Relevance
  - Would the Alternative result in variable consideration being reflected in the initial measurement of the acquired asset?
  - Could the Alternative result in the same timing for the recognition of liabilities for variable payments irrespective of whether these variable payments depend on the purchaser's future actions?
  - Could the Alternative result in a counterintuitive accounting outcome?

- Faithful representation
  - Would the Alternative result in a liability being recognised when the purchaser has no practical ability to avoid taking the action that would trigger the variable consideration?
  - Could the Alternative result in a liability being recognised that the purchaser has a practical ability to avoid?
  - Could the Alternative result in significant measurement uncertainty?

- Costs for preparers
  - Alternative 2 would be less costly for preparers to apply than Alternative 1.

The liability recognition issue

Possible criteria/thresholds 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.
- Significant unfavourable economic impact for the entity.
- Significant unfavourable economic impact related to the acquired asset.
- The asset would have to be used in a manner that would not reflect the initial economic purpose of acquiring the asset.
- Marginally economically unfavourable for the entity not to perform the activities that would trigger the variable payments.

The liability recognition issue

Initial feedback - Mixed views

Only recognise a liability when the triggering event occurs

- The purchaser does not have an enforceable (contractual) obligation to deliver anything until the point in time when triggering event occurs
- When assessing whether a liability exist, one should consider both the necessary and sufficient conditions. While the contract is necessary the contract/transfer of the asset is not sufficient for an obligation to exist
- Focus should be on the effects on profit or loss. It can be assumed that the fixed consideration reflects the value of the asset before the triggering event occurs. Therefore it would not be useful to include variable consideration in cost of asset – and therefore no liability should be recognised for the variable consideration when the asset is received
- Least costly and information needs can be met by disclosures
- Consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- An argument has also been presented that variable payments represent payments for future rights – however, such payments are outside the scope of the DP.

The liability recognition issue

Recognise liability when asset is received and no practical ability to avoid triggering payment

- Receiving the asset is the relevant past event (following the definition of a liability)
- Consistent with IFRS 15 *Revenue from Contracts with Customers* and IFRS 3 *Business Combinations*
- ‘No practical ability to avoid’ in the guidance on a liability should be interpreted so that you would generally not have a practical ability to avoid triggering the variable consideration in an exchange transaction
- Focus should be on having the acquired asset measured faithfully. This would likely involve also recognising a liability related to the variable component. However, this could be another type of liability (and presented separately) than e.g., the financial liability that would be recognised for a fixed consideration
- Better reflection of future cash flows.

The liability recognition issue

Initial feedback

- Also suggestions on approaches that would be ‘in between’. For example, recognise a liability for variable consideration that depends on the purchasers future actions if there is a high chance that the variable consideration will be triggered.
- Differing views on how ‘no practical ability to avoid’ should be interpreted.
- Measurement uncertainty should also be considered (if recognising a liability before the triggering event occurs).
- Disclosures would be important to provide information about the uncertainties – but the disclosures would be similar for the different approaches for recognition.

The measurement of the acquired asset issue

The measurement of the acquired asset issue

Causes of the issue

No explicit/clear requirements on the issue. The requirements that do exist are interpreted differently and/or are conflicting.

For example, some refer to paragraph B5.4.6 of IFRS 9 *Financial Instruments* (changes in an estimate of variable consideration should be recognised in profit or loss) while others apply IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* by analogy.

Basing requirements on:

- Guidance in the Conceptual Framework on measurement at historical cost.
- The definition of cost in existing IFRS requirements – and supporting requirements.

Both are interpreted differently

The measurement of the acquired asset issue

Illustration of different interpretations of the definition of 'cost'

a

The amount of cash or cash equivalents paid or

b

the fair value of the other consideration given to acquire an asset

a+b

at the time of its acquisition

a

The amount of cash or cash equivalents paid or

b

the fair value of the other consideration given to acquire an asset

at the time of its acquisition

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.

The measurement of the acquired asset issue

Qualitative characteristics of useful information for the Alternatives considered

- Relevance
  - Under what circumstances will changes in variable consideration that depends on factors relating to a particular period be recognised in that period?
  - Under what circumstances will changes related to future cash flows expected from the acquired asset be matched with in subsequent periods after the cost of the acquired asset is updated for remeasurements of the liability for variable consideration?
  - Could the Alternative result in counterintuitive information (i.e., recognising a gain/loss due to the decrease/increase in the estimate of a liability for variable payment when there is a decline/improvement in the expected future cash flows of an acquired asset)?

- Faithful representation/ verifiability/ comparability
  - Would the Alternative require the use of significant judgement?

- Costs for preparers
  - Alternative 1 would be least costly.

The measurement of the acquired asset issue

Initial feedback – Mixed views

Mixed input on whether/when to update:

- **Not updating**: Would be consistent with IFRS 3; perhaps least costly (however, argument also presented that this alternative would also be costly as preparers would have to explain the fluctuations in profit or loss and develop alternative performance measures).
- **Updating**: The value of the asset has changed based on the purchaser's actions; it reflects the invested capital (unless payments relate to past actions).
- **Sometimes updating** if change in estimates:
  - Are included in the measurement of the asset's cost at initial recognition.
  - Related to the initial quality of the asset (in principle – but practical problems with such an approach).
  - Reflects changes in future economic benefits from the asset (in principle – but many practical problems with such an approach) (so far favoured by most).

General IFRS requirements and standard-setting implications

Key findings

Current requirements on variable consideration (also variable consideration included in transactions outside the scope of the issues considered) are different and the reasons for the differences are seldom explained.

There is incremental complexity in accounting for variable consideration transactions paid through the transfer of a non-financial asset including by performing a service and the related non-financial liabilities. Nonetheless, the Discussion Paper’s alternatives for requirements for the recognition of liabilities and measurement of acquired assets could be applicable for these transactions.

The Discussion Paper outlines high-level advantages and disadvantages of developing unified principles versus standard-by-standard amendments. It seeks constituents’ views on these two options taking into account the usefulness of information, timeliness of solutions and cost-benefit considerations.

Possible standard-setting responses

Developing unified set of principles	• Advantages (can address two issues and inconsistencies in definition of cost; can inform narrow scope amendments). • Disadvantages (a one-size fit all solution is unlikely to be implementable, unlikely to be justified from a cost-benefit standpoint).
Standard-by-standard review	• Advantages (specific amendments might be easier to address than a comprehensive review, takes account of transaction-specific features). • Disadvantages (may fail to address both liability recognition and asset measurement issues; may perpetuate diverse approaches across IFRS Standards).

Possible standard-setting response

Initial feedback

Probably most initial support for considering it narrowly (e.g., in relation to the projects Financial Instruments with Characteristics of Equity; Provisions; and the project on intangibles). Arguments include: the time it would take to do standard setting if the IASB would not be disciplined and focused; issues are different (so therefore best to consider on a standards-by-standards level); a holistic approach will likely not result in the IASB wanting to reopen existing guidance e.g. IFRS 16 *Leases)*.

However, also debate about whether to consider whether the best way for standard setting is to consider the liability together with the asset (as in e.g., IFRS 16), or consider assets and liabilities separately.

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