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DRAFT CL-ACCOUNTING FOR VARIABLE CONSIDERATION

Dear Mr Klinz,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, we appreciate the opportunity to comment on the Discussion Paper “Accounting for variable consideration”.

Principal authors of this comment letter were Max Eibensteiner, Gerhard Prachner, Gerhard Schwartz and Anita Seiwald. In order to ensure a balanced Austrian view on the consultation, the professional background of these authors is diverse.

Best regards,
Romuald Bertl
Chairman

DRAFT CL-ACCOUNTING FOR VARIABLE CONSIDERATION

General Remarks

The discussion paper intends to give guidance to the IASB on any future standard-setting activities related to the accounting for variable consideration. Thereby, the DP focuses on two specific issues:

1) When to recognise a liability for variable consideration, if the variable consideration depends on the purchaser's future actions and
2) Whether/When subsequent changes in the estimate of variable consideration should be reflected in the cost of the acquired asset

In the light of the alternatives presented, we support a recognition of the liability and an inclusion of the corresponding amount in the cost of the related asset when the purchaser obtains control of the asset. We propose setting the threshold concerning "a purchaser entity has no practical ability to avoid taking future actions" at a level at which avoiding taking an action would have a significant unfavourable economic impact on the entity.
Regarding the second topic, we favour to update the estimate of variable consideration under specific circumstances, specifically, if the change in estimates of variable consideration occurs before the asset is ready for its intended use.

Our detailed argumentation can be found in the answers to the EFRAG's specific questions below.

QUESTION 1 - WHEN TO RECOGNISE A LIABILITY FOR VARIABLE CONSIDERATION

Chapter 2 explores two alternatives for requirements on when to recognise a financial liability for variable consideration that depends on the purchaser's future actions under IAS 32.25/IFRS 9:

a) Alternative 1: Recognising a liability when the purchaser obtains control of the asset acquired unless the purchaser would have a practical ability to avoid taking the action that would trigger the variable consideration. (The Discussion Paper includes suggested criteria on when a purchaser entity would not have the practical ability to avoid taking the action(s) that would trigger the variable consideration (see Question 2 below)).
b) Alternative 2: Recognising a liability when the purchaser performs the actions that trigger the variable consideration.

The Chapter also includes assessments of qualitative characteristics of useful information for each of the two alternatives. Do you agree with these assessments?

Relevance

i) We agree, that in case of a fully variable consideration, the recognition of the asset with nil does not provide relevant information (although such a situation might only happen infrequently). We support the argument concerning predictive value (enhanced by alternative 1), i.e., a better match of economic benefits and related depreciation/amortization of the asset, if a liability for the variable part of the consideration is recognised when control over the asset is transferred to the purchaser.

ii) We agree, as long as the “unavoidable” criterion is properly defined (see under Alternative 1 below).

iii) We agree only to a certain extent. If Alternative 2 is applied, the recognition of the expense related to the accounting for the liability partly outweighs the excess revenues that triggered the variable consideration, so the matching principle is (at least partly) fulfilled. However, a better match is achieved, if the variable part is recognised as part of the asset right at the initial recognition of the asset.

Faithful presentation

i) Again, a clear definition of the “unavoidable” criterion is key to achieve a compliance with the recognition requirements for a liability as outlined in the Conceptual Framework.

ii) Measurement uncertainty: depends on the underlying transaction, but this holds for e.g., provisions as well.

Cost for preparers

i) Alternative 1 is more costly as it includes the regular reassessment of the liability’s value and the related depreciation/amortization of the corresponding asset value. Alternative 2 only needs the observation of the potential “triggering event” for recording the liability.

Do you think that other alternatives for requirements for liabilities for variable consideration than those listed should be considered? If so, please specify these other alternatives.

N/A

When do you think a purchaser should recognise a financial liability covered by IFRS 9 for variable consideration that would depend on the purchaser’s future actions? Please explain your answer.

- Alternative 1 provides more useful information as the potential (the term from the asset definition contained in the Conceptual Framework) of future economic benefits is better reflected. However, we propose supplementing the notion “obtained control” with “and the asset is able to operate in the way intended by management” to limit the period of time during which a variable consideration (and its change) can be considered as part of the asset’s carrying amount.
- This solution would then be aligned with the requirements of IAS 32/IFRS 9 for variable consideration that is independent from a purchaser’s future action.
- There are some terms that need further clarification, such as “future actions” and the difference to “future performance” (see 2.16 a). However, IAS 32.25 is quite clear in respect to some of the main determinants of variable consideration, such as the “issuer's revenues", "net income"

and "debt-to-equity-ratio". These are listed as examples of uncertain future events that are beyond the control of the issuer or the holder (in that case, of a financial instrument). The DP's illustrative examples will, under the described circumstances, lead to the recognition of a liability – with the next step to provide an estimate of the amount (in many cases, calculating an expected value will be sufficient).

- As far as the definition of the "unavoidable/avoidable" criterion is concerned we have preferences for alternative b) "significant unfavourable impact on the entity". It is less extreme than the other two ("ceasing business" and "unfavourable in the context of the asset"). As second-best solution we would opt for "ceasing business", as it ensures that in almost all cases, a liability for variable consideration would be recognised. As we are in favour of Alternative 1, the softer criteria c) to e) would result in a large scope of interpretation, opening the way for prolonged diversity in practice.

- Alternative 2**:** it is easier to apply, there are lower implementation costs as no subsequent estimates of the liability's value are required.
- If purely relying on the Conceptual Framework, this alternative is the logical result => as long as the threshold in the example is not exceeded, there is no present obligation. The only exception would be that the delivery of the asset is the obligating event and only the amount and timing is uncertain.

Are you aware of any issues relating to the measurement of a recognised financial liability for variable consideration? If so, please elaborate on these issues.

N/A

QUESTION 2 - HOW TO ASSESS THAT AN ENTITY HAS NO PRACTICAL ABILITY TO AVOID TAKING AN ACTION

Chapter 2 suggests five alternative criteria for assessing when a purchaser would have no practical ability to avoid taking an action which would trigger a variable consideration (when the purchaser is not legally or constructively obliged to perform the future actions). The five suggested criteria are:

a) When avoiding taking an action would mean that the purchaser would have to cease its activities.
b) When avoiding taking an action would have a significant unfavourable economic impact on the entity.
c) When avoiding taking an action would have a significant unfavourable economic impact in the context of the acquired asset.
d) When avoiding taking an action would result in using an acquired asset in a manner that would not reflect the economic purpose of acquiring the asset.
e) When avoiding taking an action would have marginal economically unfavourable consequences for the entity.

Do you agree that the above criteria are valid for assessing whether a purchaser would not have the practical ability to avoid performing a future action that would trigger variable consideration?

We agree, although from our point of view criteria c) to e) are hard to use in practice and would need further refinement. E.g., what is meant by “unfavourable in the context of the acquired asset” as used in c). How can a user/auditor question the “economic purpose of acquiring the asset” (as used in d)) if the purchaser does not reveal this purpose in the first place. The term “marginally unfavourable” as used in alternative e) adds a new notion to the IFRS and needs further specification. Replacing it by “immaterially” could avoid to add still another concept to the already vast universe of IFRS terms.

Are there other criteria that should be considered? If so, please elaborate on these other criteria. Which of the above criterion/criteria would you prefer and why?

We prefer alternative b) as it is straight-forward to assess and less open to interpretation. For details see the last bullet point under Alternative 1 in Q1 above.

QUESTION 3 - INTERPRETATIONS OF THE DEFINITION OF COST

Chapter 3 notes that the definition of ‘cost’ included in IAS 16, IAS 38 and IAS 40 (“the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, e.g., IFRS 2 Share-based Payment”) is interpreted differently.
How do you interpret current requirements in relation to whether/when the measurement at cost of an asset covered by IAS 16 or IAS 38 should be updated to reflect changes in estimates of variable consideration?

We follow a similar approach as outlined in IFRS 3 and IAS 16 (for restoration cost): to include the initial estimate of the variable consideration at initial recognition (which lasts until the asset is ready for its intended use). Further changes up to the point when the asset achieves its intended state of use should be adjusted as defined by IFRIC 1 (and, for certain changes of lease agreements, by IFRS 16), i.e., with a simultaneous increase/decrease of the liability and the associated asset.

How do you think ‘cost’ should be defined to provide the most useful information and do you think it is useful to consider that measurement at cost should be similar across all IFRS Standards?

We doubt that a single definition of the term "cost" would lead to more relevant information. Moreover, it might infringe the requirement for faithful representation as e.g., “historic cost” and “amortized cost” address different underlying facts and future consequences.

QUESTION 4 - POSSIBLE REQUIREMENTS FOR WHEN MEASUREMENT AT COST SHOULD BE UPDATED TO REFLECT CHANGES IN ESTIMATES OF VARIABLE CONSIDERATION

Chapter 3 explores the following three possible alternatives for requirements for when the cost of an asset should be updated in situations where the asset is acquired in exchange for variable consideration in cash or another financial instrument:

a) Alternative 1: Not updating the cost estimate.
b) Alternative 2: Updating the cost to reflect all subsequent changes in estimates of variable consideration.
c) Alternative 3: Sometimes updating the cost of an asset. The Discussion Paper lists the following criteria which could be used to determine when the cost of the asset should be updated.

One or several of the criteria could be used:

- ***Update if estimates of variable consideration are included in the measurement of the asset's cost at initial recognition.***
- ***Update if the change in estimates of variable consideration takes place before the asset is ready for its intended use.***
- ***Update the cost to the extent that variable payments are associated with future economic benefits to be derived from the asset.***
- ***Update the cost to the extent that variable consideration is linked to the initial quality of the asset.***

Do you think that other possible requirements than those explored in the Discussion Paper should be considered? If so, what are these other requirements?

N/A

Chapter 3 presents the qualitative characteristics of useful information for the three possible alternative requirements (including the four different criteria under Alternative 3) for when measurement at cost should be updated to reflect changes in estimates of variable consideration. Do you agree with the assessed characteristics of useful information for the alternatives? If not, which elements should be considered, and which assessments do you disagree with?

Relevance:

i) Timing and matching

a) We agree. If the income effect of the transaction/event triggering the variable consideration affects only one specific period, recognising the related expense fully in that same period would lead to relevant information. In such cases, Alternative 2 from Question 1 (recognising the consideration when the condition is met) would be the preferred solution. However, even if an amount had been recognised at initial recognition of the asset, the same effect can be achieved by recognising an impairment on the asset as reduced expected future cash flows will likely lead to a reduced recoverable amount.

b) We agree with the analysis provided for matching income and expenses.

ii) Counterintuitive information: We agree that not recognising the liability amount related to the associated asset might lead to an unsound recognition of expenses, if it is triggered by an increase of the asset's ability to generate cash flows (e.g., as mentioned in the example about a trigger related to the entry in a new market). This would suggest Alternative 1.

iii) Faithful presentation: Although all estimates for a variable consideration contain a certain degree of judgement, we see an increased risk of subjectivity in criteria 3 and 4 as the boundaries of "future economic benefits to be derived from the asset" can be drawn closer or wider and it might be hard to exclude the influence of other assets (which might be needed to make the asset under consideration viable) from an assessment. As far as the "initial quality" of the asset is concerned, this criterion would only be applicable, if the purchaser's expectations are revealed at initial recognition to allow to check the actual outcome against this benchmark. In fact, the term "quality" might better be replaced by "expected performance" or "expected output".

When do you think 'cost' should be updated to reflect changes in estimates of variable consideration? If you think that 'cost' should sometimes be updated, under what circumstances should it be updated?

Our preference is for Alternative 3, thereby using criterion 2 (before the asset is ready for its intended use). Both are well known notions and are easily applied whenever there is no variable consideration concerned. Criteria 3 and 4 allow for substantial divergences in the interpretation. Especially the direct link of the specific asset's performance and future economic benefits will not always be easy to prove. Where does the contribution of the asset end and where does the effect of an improved economic environment begin? Moreover, the Conceptual Framework clearly connects (historic) cost with the date the asset is acquired or created, so future performance is no issue in this respect. The standards commonly associated with this concept of cost are IAS 38 for intangibles and IAS 16/IAS 40 for PPE (thus mainly the areas which are treated by the DP). The upper boundary of cost recognition according to these standards is the moment when the asset is "capable of operating in the manner intended by management" and nothing beyond. Future adjustments of the initial costs almost always (except for the unwinding of a discount) reflect a reduction of the value related to its regular consumption (depreciation/amortization) or its impairment.

Always updating the asset value would to some extent require the use of hindsight. The more remote a future update from the initial recognition occurs, the less likely it is that the trigger is still related to the original asset. Moreover, the trigger for the variable consideration might not be the performance of the asset itself, but might be due to "external" circumstances like changes in the economic/political/etc. environment, thus depending on facts that might not have been considered in the initial estimate of its value.

Never updating the cost estimate would mislead the user as there must be some economic rationale behind the acceptance of a variable consideration as part of the purchase price of an asset. Never updating (i.e., not even until the asset is ready for its intended use) would hide a part of its earnings potential as well as of the cost (= depreciation) associated with this potential.

To IFRIC 1: In fact, dismantling and/or restoration are special cases of an obligation that exists right from the initial recognition of an asset (there is no uncertainty whether the trigger will occur, it already has) and only the amount is variable. Moreover, the variability does not depend on the performance of the asset, but on the changes of the costs for dismantling, recultivation or aftercare and the discount rate applied to the liability. However, as a (partially) similar concept prevails in IFRS 16 Leases, it can be validly assumed that a parallel movement of liability and asset is at least not an "outdated" feature in the IFRSs.

QUESTION 5 - GENERAL REQUIREMENTS ON ACCOUNTING FOR VARIABLE CONSIDERATION

Chapter 4 complements Chapters 2 and 3 of the Discussion Paper by assessing the broader requirements for accounting for variable consideration. Chapter 4 examines the advantages and disadvantages of respectively developing a unified set of principles for IFRS requirements to account for variable consideration and undertaking Standard-by-Standard amendments that could apply to the two issues covered in Chapters 2 and 3 (i.e., liability recognition when payment depends on purchaser's future actions and measurement of the acquired asset).

Do you agree with the advantages and disadvantages identified?

Yes.

Based on your assessment and the outlined advantages and disadvantages of respectively developing a unified set of principles for IFRS requirements to account for variable consideration and undertaking a Standard-by-Standard amendment, which of the standard-setting responses do you support?

As only equal things shall be treated alike, we prefer standard-by-standard amendments. However, we are of the opinion that standards currently using identical cost concepts shall be updated in the same way. It could be considered, whether only a limited number of cost concepts shall be used in the future.

Do you think that requirements to deal with the issues mentioned in Chapters 2 and 3 should be based on a unified set of principles for how to account for variable consideration?

As outlined in 4.72, targeted amendments will most probably resolve most cases of diversity in practice. Such an approach will be implemented more swiftly than running through a process of defining unified principles.

QUESTION 6 - APPLYING AN IFRS 15 MIRRORING APPROACH

Chapter 4 notes that requirements on variable consideration included in IFRS 15, could be 'mirrored' to provide guidance on how to account for a liability for variable consideration (with

the exception of the constraint to only include in the transaction price the amount of variable consideration that is highly probable not to result in a significant reversal in the amount of cumulative revenue recognised).
Do you think such an approach would result in useful information? Please explain why or why not?

We are of the opinion that the regulations set out in IFRS 15 (use of the expected value or the most likely amount) and IAS 37 (expected value as outlined in IAS 37.39 or single value as defined by IAS 37.40) provide almost the same information when estimating the variable consideration at initial recognition/at the time the asset is ready for its intended use. The main difference is the criterion used to account for the liability in the first place ("highly probable" versus "more likely than not"). As we support the recognition of variable consideration at initial recognition, the lower threshold required by IAS 37 is more consistent with this view than the application of the IFRS 15 mirror approach.