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Dear Vincent

Submission On
EFRAG Discussion Paper: Accounting for Variable Consideration - from a Purchaser's Perspective

You asked the New Zealand Accounting Standards Board (NZASB) put in a submission on the EFRAG Variable Consideration Discussion Paper (DP). Unfortunately, the NZASB does not have the capacity to respond to the DP, especially as it is now coming up to the summer holiday period. As an alternative, the XRB has asked me to provide a submission.

I welcome the opportunity to comment on the DP. In the appendix to this covering letter, I summarise my experience in standard setting.

I have discussed various aspect of the DP with colleagues, XRB board members and XRB staff. In most cases the views were similar to my own. For one issue, however, there was a difference in views. I have reported both views in this submission.

While I have consulted with others, this submission is made in a personal capacity. The views expressed are my own and do not represent positions of the XRB or any of its sub-boards (NZASB and the NZAuASB).

Prior to commenting on these specific issues, I make some comments of a general nature on the DP.

Sincerely

Professor Emeritus
Massey University
14 December 2023

Appendix: Experience in Standard Setting
I am currently a board member of the New Zealand External Reporting Board (XRB) and the New Zealand Accounting Standards Board (NZASB). The XRB is an independent Crown entity responsible for developing and implementing an overall strategy for financial reporting standards, auditing and assurance standards and climate related disclosure standards. The NZASB is a sub-committee of the XRB responsible for developing accounting standards.

I have had extensive involvement in national standard setting. I was a member of the (New Zealand) Financial Reporting Standards Board from 2000 to 2009; the Financial Accounting Committee 1987-1996; and various working groups (financial instruments, intangibles, public benefit entities) 1997 –2008.

I have been a member of the IFRS Advisory Council (2012-2014); IFRIC (2004-2008); and the Financial Instruments International Joint Working Group of Standard Setters (1998-2000). I was a member of the Academic Advisory Panel of the Australian Accounting Standards Board (2017 -2021).

Prior to academia I spent over 10 years with a large international accounting firm, both in New Zealand and London. I have authored or co-authored many professional and academic research papers on issues relating to governance, auditing, financial reporting and financial analysis.

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- from a Purchaser's Perspective

General Comments on the DP – Arguments by Analogy

One of the strengths of the DP is that it provides an extensive review of the issues surrounding the accounting for variable consideration. Many of the arguments in the DP are "by analogy" to other IFRS. In my view, many of these arguments are not valid. As a consequence, I think the analysis using the qualitative characteristics is premature, because it gives some of these arguments a semblance of validity they do not deserve.

The potential argument by analogy comes from IAS 8, which allows the consideration of "IFRS dealing with similar and related issues" (IAS 8.11(a)). However, it should be noted that the directions in IAS 8, with regard to arguments by analogy, only apply to changes in accounting policy and not to changes in an accounting estimate. In my view adjusting liabilities or assets for variable consideration is a change in estimate, not a change in accounting policy. Therefore, it is not obvious that argument by analogy is appropriate. At a minimum, it suggests that more weighting is given to fundamental concepts in the *Conceptual Framework*, than analogies to other accounting standards.

Assuming that argument by analogy is appropriate, then care needs to made over the judgement of what is "similar and related". In many cases the analogy referred to is not a principle or a concept, rather it is an illustrative example or an exemption. For example, volume discounts and rebates are examples of accounting for the transaction cost component of historic cost rather than the cash or cash equivalent component. Reference to regulatory assets and liabilities is unlikely to be relevant in accounting for commercial transactions. In other arguments, the analogy from another standard might be an exception to the general principles in the *Framework.*

Regardless of whether the DP is considered to be an interpretation or is trying to postulate new ideas, it should focus on concepts and principles not examples or exemptions.

IAS 10 is, perhaps, the most relevant standard because it contains a principle on how to account for subsequent changes in events and conditions that affect an accounting estimate. IAS 10 distinguishes between events that (1) provide evidence on a transaction that existed at the end of the reporting period and (2) evidence that is indicative of conditions that arose after reporting period. While IAS 10 is not directly applicable (unless the variable consideration adjustment is an event subsequent to balance date), the underlying principle is considered relevant for the determination of historic cost "at the time of acquisition or construction" (IAS 16 6). There is a natural assumption (if not a rebuttable presumption), that for any unexpected variable consideration adjustment, these would be caused by changes in conditions after the asset has been acquired. That is, in order to capitalise unexpected variable consideration adjustments to the related asset, the onus would be on the purchaser to demonstrate that any such adjustments were changes in the estimate that existed at acquisition date and not changes due to subsequent events.

General Comments on the DP – Terminology
The DP often uses the term "variable consideration", when more specific terminology might be appropriate. If the expected variable consideration is capitalised into the cost of the asset at acquisition date, then the *variable consideration adjustment* would be more accurately described as the *unexpected variable consideration adjustment*.

Specific Questions Posed in the DP -

Question 1 - When to recognise a liability for variable consideration

There was unanimous agreement, among the colleagues I surveyed, that the liability should be recognised when the asset is received (Alternative 1). The traditional accounting model is transaction based. When the purchaser obtains control of the asset the contract becomes non-executory. At this point, the liability **exists**. The variable consideration determines the **amount** of the liability but not **when** the liability exists. Thus, the purchaser recognises its best estimate (including any discounting) of the expected liability.

Question 2 - How to assess that an entity has no practical ability to avoid taking an action

The were strong views that the conditions relating to "no practical ability" should be as stringent as possible. One strongly held view was that this condition should not exist in accounting standards, because it dilutes the distinction between equity and liabilities. That is, if an entity has no practical ability to not pay a dividend it might have no equity. This is certainly problematic for certain co-operative structures and may well apply to large blue-chip companies.

A director's view on variable consideration within purchase contracts is that they are often real options (i.e., an option to abandon and modify the project or asset). Thus, regardless of whether the entity has the ability or not to avoid taking action, this real option is a component of fair value and therefore considered to be part of the cost at acquisition.

Question 3 - Interpretations of the definition of cost

The *Conceptual Framework* (para 6.5) states that historical cost of an asset **when it is acquired** or created is the value of the costs incurred in acquiring or creating the asset, comprises the consideration paid to acquire or create the asset plus transaction costs (emphasis added). Thus, it is incorrect to state that the *Conceptual* Framework does not specify the date when historic cost is measured. IAS 16.6 is more specific. The cost of the asset is "the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition" (IAS 16.6),

The historic cost or fair value at acquisition would include an estimate of the value of the variable consideration. It is unlikely that this amount would be zero. In subsequent periods, realised measurement errors relating to the variable consideration will be expensed. Of course,

the realised variable consideration may indicate that impairment of the asset may be necessary. The entity might also be able to use the revaluation model under IAS 16.

Question 4 - Possible requirements for when measurement at cost should be updated to reflect changes in estimates of variable consideration

Among the colleagues I surveyed there were two views on this question.

View 1. The strong majority view was that beyond initial recognition, the asset and the liability are accounted for independently. This concept is strongly supported by economic theory. The well-known Modigliani-Miller theorem states that the market value of a company is calculated as the present value of its future earnings and that the values of the underlying assets are independent of the company's capital structure.

This concept is currently applied in accounting, to contracts where a liability is related to (or initially funds) an acquired asset. Examples include, leases and a foreign currency borrowing.

The *Conceptual Framework* (para 6.7) specifies the conditions where changes in the historic cost of the asset can be updated over time. None of these conditions relate to changes in the liability of a related estimate.

The principle in IAS 10 would allow changes in the cost of the asset only where the subsequent event reveals evidence relating to the estimate of historic cost at acquisition date. Any subsequent change in the liability, due to the variable consideration, is almost certainly to be due to changes in external events or actions by management rather than conditions that provide information on the estimates made at acquisition date.

View 2. Another view, would allow very restricted adjustments to the cost of the asset. For example, IAS 16.20 states that the costs in the carrying amount ceases when the item is in the location and condition necessary for the asset to be capable of operating in the manner intended by management. This, does not negate the principle of accounting independence between the asset and liability, but merely moves the acquisition date from when control is first obtained.

However, a counter-argument is that IAS 16.16 relates only to "costs directly attributable" to bringing the asset to its location and condition. That is, the variable consideration relates to the liability not the asset and is not a directly attributable cost. Furthermore, IFRS 9 requires subsequent remeasurement of a recognised liability to be recognised in profit or loss.

Question 5 - General requirements on accounting for variable consideration

If the diversity of practice relating to variable consideration is as great as the DP suggests then there is a need for a standard setting response. This response would be to examine the various inconsistencies of interpretation of standards and between standards. This DP is an excellent starting point for that discussion. However, I also add the caution that this decision can only

be made in context of other agenda priorities, The market is still absorbing IFRS 15 and 16. In addition, many jurisdictions are going through the reporting of climate related disclosures and sustainability disclosures.