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Definition of variable and contingent consideration
Issues Paper

Objective

1 The objective of this session is to decide on a preliminary definition of variable and contingent consideration.

2 The EFRAG Secretariat considers that it would be beneficial for EFRAG TEG to decide on a preliminary definition of variable and contingent consideration as:

- (a) EFRAG TEG members (and the EFRAG Secretariat) would have a common understanding of the term when discussion the topic;
- (b) It would be necessary when considering:
  - (i) the effects of various proposals on how to account for variable and contingent consideration; and
  - (ii) the scope of the project, including the types of variable and contingent consideration that should be considered and which related issues should be addressed.

Definition of “variable and contingent consideration”

3 Since the May 2019 TEG meeting and based on some of the comments made by members at that meeting, the EFRAG Secretariat has identified some issues related to the temporary definition previously discussed. The previous temporary definition stated that a consideration is not variable or contingent if it is:

- (a) A fixed amount in the functional currency of the entity; or
- (b) An amount in the functional currency of the entity which is only adjusted by an interest rate reflecting a financing component; or
- (c) An asset (including a service) or a group of assets that are specified and held by the entity before it received the asset it is exchanging its assets for; or
- (d) A fixed number of the equity instruments of the entity; or
- (e) Any combination of the above.

4 Based on subsequent analysis, the EFRAG Secretariat suggests that an entity is providing variable consideration in an exchange for an asset if:

- (a) the entity is not transferring a fixed amount in its functional currency; or
- (b) the terms of the exchange have not been agreed to a significant extent in advance of the exchange and the consideration is transferred at a single point in time, rather than over time or at multiple points in time.

5 Consideration is contingent if there is uncertainty as to whether the requirement to transfer the consideration would meet the definition of a liability.

6 When defining variable and contingent consideration, the EFRAG Secretariat has tried to avoid specifying which entity is the buyer and which entity is the seller. Instead, it has considered that both entities in a transaction make a contribution. Some contributions can be in cash while others can be in the form of transferring an asset (a good or a service). This means that if an entity, for example, is providing a cleaning service (which is considered to be an asset that is consumed immediately) in exchange for a television or cash, that entity is making a contribution in the form of the cleaning service. It is therefore necessary to consider when the transfer of an asset or a group of assets is variable consideration.

7 The reasons for the changes are explained below for each of the criteria developed by the EFRAG Secretariat for the May 2019 EFRAG TEG meeting (see paragraph 3 above).

8 The EFRAG Secretariat also has included an additional section considering how to distinguish 'contingent' and 'variable'.

A fixed amount in the functional currency of the entity

9 The starting point for the criteria suggested for the May 2019 EFRAG TEG meeting and for the temporary definition suggested in paragraph 4 is that a consideration in a fixed amount in the functional currency of the entity is a fixed consideration. On the other hand, a consideration in the functional currency of the entity that is not fixed is variable consideration.

10 This means that a transfer of a fixed amount in the functional currency of the entity is considered to be fixed even if there is a time lag between the time when the amount is set and when it is transferred. When assessing whether a consideration is fixed or not, it is thus not considered whether the amount corresponds to the fair value of the asset received in exchange for the amount transferred at the time of the transfer. Similarly, the assessment would also not take into account that (normally) a given amount paid at a later point in time is worth less than the same amount paid earlier.

11 It follows from paragraph 10 that if the reporting entity has agreed to purchase an asset from the seller in the future at the market price at the time of the transfer, the consideration will be considered variable. On the other hand, if the reporting entity has either explicitly or implicitly entered a forward contract to purchase the asset from the seller at a fixed price, the consideration is considered to be fixed. Whether or not the consideration for an asset that has not yet been received is variable is independent of:

(a) Whether the initial measurement of the asset corresponds to the fixed consideration or not. In other words, when the consideration is agreed before a transaction takes place, the initial measurement at cost of the acquired asset does not provide any evidence on whether the consideration was fixed or not.

(b) The fair value of the exchange agreement. The consideration can be fixed even though the value of the agreement is positive or negative.

12 If a reporting entity enters into an agreement with another entity to purchase an asset for a variable or conditional consideration and at the same time enters into an agreement with a third entity which essentially results in the net outflows of the reporting entity being fixed, the consideration is nevertheless not regarded as fixed under the approach suggested in this paper. This paper suggests that whether or not a consideration is variable should be considered within the boundaries of the transaction between the two entities. In addition, if the variability of a consideration is hedged by a third entity, there would always be a risk that the third entity would not honour its obligation – and the consideration would thus be variable anyway.

13 The requirement to consider any amount except for a fixed amount in the functional currency of the entity to be variable or contingent could result in the consideration

being considered and accounted for differently by the two entities in the exchange. This would happen if the entities have different functional currencies. The requirement would also mean that a transaction could be accounted for differently in the consolidated financial statements of a group depending on which entity in the group makes the transaction. Again, this could arise if entities in the group have different functional currencies.

14 To avoid this, it could be proposed that:

(a) Whether or not the currency is the functional currency of the entity should not be considered when deciding on whether or not an amount is variable or contingent. This would mean that as long as an amount would be fixed in any currency, it would not be variable or contingent. However, it may be difficult to find good arguments for considering an amount that could fluctuate in any currency as fixed, and at the same time consider an amount linked to a non-currency variable, for example a share price index, to be variable.

(b) Consideration denominated in the functional currency of any of the entities in the transaction could be regarded as fixed consideration. An argument against such an approach would be that similar transactions in the same foreign currency might be accounted for differently depending on whether or not that foreign currency is the functional currency of either entities in the transaction. A practical problem with such an approach would be that the entities in the transaction would need to know the functional currencies of each other.

(c) Consideration denominated in the functional currency of any of the entities in a group could be regarded as fixed consideration. Arguments against such an approach could be that:

(i) The individual (or sub-group consolidated financial statements) of an entity in a group would be affected by which other entities are controlled by the ultimate parent entity (unless a transaction would be accounted for differently in the individual financial statements of an entity and in the consolidated financial statements of its parent(s)).

(ii) Whether a transaction could be considered fixed or not could change quickly (by the acquisition or disposal of an entity in the group).

(iii) The fact that the group would have a tiny entity with a particular functional currency could have a significant impact on the accounting.

15 Because of the issues with the alternative approaches outlined in paragraph 14 above, the EFRAG Secretariat proposes that all amounts in a currency that is not the entity's own functional currency should be considered variable.

16 Consideration can be variable because the quality of the asset received in exchange for the consideration is unknown and it is agreed that the price will reflect the quality. However, consideration is not variable just because there is a chance that the quality of the asset received in exchange for the consideration does not meet the specifications or reasonable expectations, and the provider of the asset agrees to refund (part of) the consideration or provide a warranty or this results from the outcome of a court case.

17 However, if the quality of an asset received is too poor and it is therefore uncertain whether the entity has to pay any consideration for the asset, the consideration may be contingent following the terminology suggested in this paper (see paragraphs 35 - 42 below).

An interest rate reflecting a financing component

18 In the agenda papers for the May 2019 EFRAG TEG meeting, the EFRAG Secretariat suggested that an amount in the functional currency of the entity that is

fixed except for an adjustment reflecting a financing component should be considered to be fixed.

19 EFRAG TEG members noted that it was not clear whether the interest rate reflecting the financing component could be fixed or variable (reflecting a fixed fair value of the debt). The EFRAG Secretariat has considered the issue but would suggest this not be specified in the definition of variable consideration. The reason is that the provision of a financing component could be considered to be a separate service acquired by the entity purchasing the asset. The general guidance would therefore also apply to this component. Accordingly, the consideration would only be variable in cases where the interest rate is not fixed (which includes zero). This would mean that:

(a) Changes in the fair value of a fixed-interest loan would not be considered variable consideration.

(b) If a loan is provided for an indefinite period of time the payment would be fixed for the entity (which is borrowing the money) if the interest for the following period is set for a point in time at which the reporting entity can repay the loan. For example, if the reporting entity can repay the loan at the beginning of any month (without any penalty) and the interest for the month is determined at the beginning of the month, the consideration is considered to be fixed. This case can be considered similar to a case in which the entity is borrowing an amount at a fixed interest at the beginning of each month. Similarly, if the entity can repay a known or determinable amount at any time (for example, if it would have to pay a given market rate plus 2 percentage points), the consideration would be considered to be fixed. On the other hand, if the entity can repay the loan at the beginning of the month but the interest for the month is only determined at the end of the month (for example, as the average market rate of the month plus 2 percentage points) the consideration would, for the purposes of this project, be considered variable.

An asset (including a service) or a group of assets that are specified and held by the entity before it received the asset it is exchanging its assets for

20 As noted above, when defining variable and contingent consideration, the EFRAG Secretariat tried to avoid specifying which entity is the buyer and which entity is the seller. Instead, it is considered that both entities in a transaction make a contribution. Some contributions can be in cash while others can be in the form of transferring an asset (a good or a service).

21 In most cases, it is clear whether the transfer of an asset or a group of assets is fixed consideration or not. In cases in which the transfers take place immediately after the exchanges have been agreed and there would be no subsequent changes in the assets to be transferred, the consideration is fixed. Similarly, if a reporting entity might subsequently have to transfer additional assets (or receive transferred assets back), the consideration may be variable or contingent.

22 If the transfer does not take place at a specific point in time, but over time (for example, if the consideration is a cleaning service every Monday for one year), the consideration is variable, as the costs (in the functional currency of the entity) of providing the asset are not fixed.

23 It may be less evident when consideration should be considered variable or fixed if it has been agreed significantly in advance of the transfer[1]. For example, if it has

[1] The EFRAG Secretariat acknowledges that this discussion could be considered less relevant as there may not be any identified accounting issues related to variable or contingent consideration before an exchange takes place. A contract to exchange assets in the future would be executory and would normally not be recognised in the financial statements unless the assets are financial instruments. The contract would, however, be recognised if it is deemed onerous.

been agreed that in six months, the entity will transfer one asset in exchange for another asset.

24 In a case in which it has been specified what asset or group of assets an entity has to transfer before it receives the asset it is exchanging its assets for, the EFRAG Secretariat had previously considered the consideration to be fixed. The argument has been that the value of the contract may change (like the fair value of a loan at a fixed interest rate) but the consideration to be transferred is fixed. For example, if it has agreed that one entity has to transfer a banana (and will receive an apple or EUR 1), the transfer of the banana does not change although the value of the banana may change.

25 However, some of the issues with this approach are:

(a) A specified group of assets held by the entity before it receives the asset it is exchanging those assets for could be coins and notes in a foreign currency. It appears inconsistent that an amount an entity would have to pay in a foreign currency would be considered variable or contingent consideration whereas the transfer of foreign currency held by the entity before the exchange would not.

(b) A specified group of assets held by the entity before it receives the asset it is exchanging those assets for, could be assets that could be purchased on the market, for example one kilo of gold. It seems inconsistent to consider that if it has been agreed that the entity should transfer one kilo of gold it holds before the exchange, the consideration is fixed, whereas the consideration is variable if the entity would have to pay an amount corresponding to the value of one kilo of gold.

(c) It could be unclear whether consideration is fixed or not. For example, if the entity has the option to either pay in cash an amount corresponding to the value of one kilo of gold or transfer one kilo of gold (and by coincidence it holds one kilo of gold as the agreement is entered into).

26 The issue mentioned in paragraph 25(a) could be solved by only considering non-monetary items. That is, the position that an asset or a group of assets that are specified and held by the entity before it received the asset it is exchanging those assets for, is fixed consideration, would only apply to non-monetary assets. This solution, however, would not work for the issue identified in paragraph 25(b) and 25(c).

27 The EFRAG Secretariat has considered whether the issues identified in paragraph 25 could be solved by only considering the transfer of assets worth a fixed amount in the entity's functional currency to be fixed consideration. This would mean, for example, that if it is agreed to exchange one particular model of a washing machine for one particular model of a vacuum cleaner in one month, the consideration would be variable. At first glance this could seem counterintuitive. However, this situation does not seem different from a situation in which it is agreed that an entity (with Euro as its functional currency) has to pay an amount in Argentine Pesos in one month in an exchange for a vacuum cleaner. As noted above, the EFRAG Secretariat considers that the consideration in such a transaction should be considered to be variable.

28 The approach would also mean that an agreement to transfer washing machines equal to an amount of EUR 1 000 (the functional currency of the entity) in exchange for ten vacuum cleaners, would not be a variable consideration, as the number of washing machines to transfer would vary (depending on the price of washing machines). It could be argued that this situation would be similar to a situation in which the entity has to pay an amount in Argentine Pesos corresponding to EUR 1 000. It could be further argued that the latter transaction in effect is the transfer of EUR 1 000.

29 The EFRAG Secretariat, however, rejected the idea that an agreement for a future transfer of an asset equal to a specific amount in the functional currency of the entity should be categorised as fixed consideration. It did so on the grounds that the value of a given asset could be difficult to determine and, primarily, because the cost to the entity of providing a given asset could be very different from the value it may be considered to have in the transaction. The cost of providing the asset could also change depending on how the entity would eventually choose to provide the asset. For example, if the entity has to provide an apple, the cost (measured in the functional currency of the entity) would be different depending on whether the entity buys an apple in the supermarket or grows the apple itself.

30 On this basis, the EFRAG Secretariat suggests that an agreement to transfer assets (other than an entity transferring cash in its functional currency), at a future point in time, would always be variable consideration. This would also mean that if an entity has an option to transfer either EUR 1 000 or assets worth EUR 1 000, the consideration should be considered variable.

31 The EFRAG Secretariat acknowledges that if the terms of an exchange have not been agreed significantly in advance of the transfer, the cost of transferring, for example an apple, may depend on whether the entity has purchased the apple or grown it. However, as long as the terms have not been agreed such long time in advance that the cost of the consideration could change, this would not mean that the consideration is variable.

A fixed number of the entity's own equity instruments

32 It follows from paragraph 4.10 of the *Conceptual Framework for Financial Reporting* that own equity instruments are not economic resources of the entity itself. Therefore, a transfer of own equity instruments would not be considered to be an outflow of economic resources. It could therefore be argued that payments by means of own equity instruments should never be considered as variable or contingent consideration[2].

33 On the other hand, it could be argued that if an entity agrees to transfer a given number of own equity instruments and then some additional equity instruments if certain conditions are met, this would appear to be variable consideration. Following this argument, own equity instruments are considered as another type of assets of the entity. Accordingly, the EFRAG Secretariat suggests that the same approach as that suggested for assets and groups of assets (other than cash in the functional currency of the entity) is applied for consideration involving own equity instruments.

34 No matter whether own equity instruments are considered to be the transfer of an asset or not, if the entity has an option to either transfer an amount in the functional currency of the entity or own equity instruments equivalent to that amount, the consideration would be considered variable.

Distinguishing between 'contingent' and 'variable'

35 The EFRAG Secretariat has considered how to distinguish between 'contingent' and 'variable'.

36 According to the Marriam-Webster online dictionary, 'contingent' means:

[2] This could be argued to be compatible with IFRS 2 *Share-base Payment* as paragraph BC41 of the Basis for Conclusions accompanying the Standard states that: "[E]very time an entity receives resources as consideration for the issue of equity instruments, there is not outflow of cash or other assets, and on every other occasion the resources received as consideration for the issue of equity instruments are recognised in the financial statements…the expense arises from the consumption of those resources, not from an outflow of assets."

(a) Dependent on or conditioned by something else. For example, payment is contingent on fulfilment of certain conditions or a plan contingent on the weather.

(b) Likely but not certain to happen.

(c) Not logically necessary.

(d) Happening by chance or unforeseen causes or subject to chance or unseen effects or intended for use in circumstances not completely foreseen (for example: contingent funds).

(e) Not necessitated, determined by free choice.

37 'Variable', in the sense useful for this context, is defined as able or apt to vary, inconstant.

38 Based on these definitions, it might be argued that while contingent consideration would only describe additional amounts an acquiree would have to pay, variable consideration could also be used to describe situations in which the total amount would decrease. This would make 'contingent consideration' a subset of 'variable consideration'. Accordingly, it would only be necessary to refer to 'variable consideration'.

39 In order for a distinction between 'variable' and 'contingent' to have a purpose for EFRAG's project, the distinction should be able to affect how the two are accounted for. If 'contingent' is considered to be a subset of 'variable', this would not be the case, unless different types of variable consideration are accounted for differently.

40 For the distinction to have an effect, the EFRAG Secretariat suggests linking the two terms to different types of uncertainties.

41 'Contingent' could be linked to existence of uncertainty, similarly - but not identical - to how the term is used for contingent assets in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. A contingent consideration would thus exist when there is uncertainty about whether the definition of a liability would be met for the potential consideration. In most cases the uncertainty would be related to whether an obligation exists. As noted in Paper 07-02 for the May 2019 EFRAG TEG meeting, the unit of account could then influence whether the consideration is contingent or not and there do not appear to be divergent views as to whether any fixed part of a consideration would meet the definition of a liability in the *Conceptual Framework for Financial Reporting*. Accordingly, if the fixed component and the variable component(s) are considered as one unit of account, the definition of a liability would be met for the entire amount to be paid. How to account for the variable component(s) would therefore be a measurement issue. On the other hand, if the variable (or contingent) component(s) are considered to be separate units of account, divergent views exist as to whether these components would meet the definition of a liability.

42 'Variable' on the other hand could then refer to the uncertainty about the amount that will have to be transferred. There would not be any uncertainty related to variable consideration.

Separate discussion paper on the definition of variable and contingent consideration

43 It has been challenging for the EFRAG Secretariat to provide a suggestion on how to define variable and contingent consideration. Accordingly, there could be many other views on how to do it. EFRAG TEG may therefore consider it beneficial to hear the views of constituents by publishing a separate discussion paper on the issue.

44 While it would be beneficial to hear constituents' views on how to define variable and contingent consideration, the EFRAG Secretariat has identified the following disadvantages of such an approach:

(a) In most cases it would be clear whether consideration is fixed or not. Issuing a separate discussion paper on the definitions would delay the project and the discussions about more important issues.

(b) When EFRAG TEG start discussing how to account for variable and contingent consideration, it may discover aspects of defining variable and contingent consideration it is currently not aware of. A debate on how to define variable and contingent consideration could be more fruitful at a later stage when EFRAG TEG has gained more insight into the issues.

Questions for EFRAG TEG

45 Does EFRAG TEG agree with how the EFRAG Secretariat defines variable consideration in paragraph 4? If not, how would EFRAG TEG define variable consideration?

46 Does EFRAG TEG agree with how the EFRAG Secretariat defines contingent consideration (see paragraphs 5 and 35-42)? If not, how would EFRAG TEG describe contingent consideration?

47 Does EFRAG TEG consider that consideration in the form of own equity instruments would never be variable or contingent consideration (see paragraph 32)? If not, does EFRAG TEG consider that consideration in the form of own equity instruments should be considered as variable and contingent similarly to how it would be done for the transfer of assets (other than cash in the functional currency of the entity) (see paragraph 33)? If not, when does EFRAG TEG consider consideration by means of own equity instruments to be variable?

48 Does EFRAG TEG think that EFRAG should publish a separate discussion paper on the definition of variable and contingent consideration (see paragraphs 43- 44 above)?