VARIABLE CONSIDERATION – ALTERNATIVES TO ADDRESS CURRENT ACCOUNTING CHALLENGES

SUMMARY REPORT

EFRAG/BUSINESSEUROPE OUTREACH EVENT - 16/02/2023

This report has been prepared for the convenience of European constituents by the EFRAG Secretariat and has not been subject to review or discussion by neither the EFRAG Board nor the EFRAG Technical Expert Group. It has been reviewed by the speakers at the event.

Background

EFRAG and BusinessEurope organised an outreach event on 16 February 2023 to discuss alternatives to address current accounting challenges in relation to variable consideration – from the purchaser's perspective.

The event was built on EFRAG's Discussion Paper (DP) '*Accounting for variable consideration – from a purchaser's perspective*'. The DP examines different directions for requirements in relation to:

- When to recognise a financial liability within the scope of IAS 32 *Financial Instruments: Presentation*/IFRS 9 *Financial Instruments* for variable consideration that will depend on the purchaser's future actions ('the liability recognition issue').
- Whether (and if so, when) changes in the estimate of a liability for variable consideration should either: (i) result in updating the cost of the acquired asset that is held by the purchaser; or (ii) be recognised in profit or loss ('the measurement of the acquired asset issue').

Following the presentation of the DP, panellists with different types of backgrounds discussed the two issues.

The views expressed by the panellists during the outreach event were their personal views and did not necessarily represent the views of the organisations or companies they were associated with.

The audience provided their views on the messages shared by the panellists by replying to polling questions. Also, the audience interacted with the panellists by providing comments and questions to the speakers.

The programme of the event can be found here. The biographies of the speakers and panellists can be found here.

Welcome

Saskia Slomp, EFRAG CEO, welcomed all the participants to the webinar and announced the extension of the deadline for the DP's public consultation from 31 May to 30 November 2023.

Presentation of EFRAG's Discussion Paper Accounting for variable consideration – from a purchaser's perspective

Malgorzata Matusewicz, EFRAG FR TEG member and Partner at EY, introduced EFRAG's Discussion Paper '*Accounting for variable consideration – from a purchaser's perspective*', issued in September 2022, and outlined the different alternative directions for requirements considered in the DP and their advantages and disadvantages.

Discussion

1. Panel discussion of the liability recognition issue

Michael Fechner, EFRAG FRB member and Manager at Mercedes-Benz Group AG's Accounting Department, introduced the debate and highlighted again that the views expressed by panellists were their personal views and did not necessarily represent the views of the organisations or companies they worked for.

To set the scene, he provided the following example (based on Illustration 4-2 Contingent consideration relating to a football player's registration in Chapter 17 of EY's International GAAP 2023) which panellists would use to illustrate their views:

> 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 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.

Panellists then discussed:

- situations in which the liability recognition issue arises
- when is/should a liability be recognised for variable consideration that depends on the purchaser's future actions?
- when does a purchaser not have a practical ability to avoid taking an action that would trigger variable consideration?
- complexities and cost of alternatives for requirements
- guidance in the Conceptual Framework for Financial Reporting
- the approach to standard setting.

Situations in which the liability recognition issue arises

Michael Stewart, Senior Expert of Financial Reporting at Huawei, thought that there are two situations under which variable consideration is used. The first situation is when the fair value of the asset being sold is unknown at the transaction date. In this case, variable consideration is used to adjust the consideration when more information will be available, to reflect the fair value of the asset transferred at the transaction date. The second situation is when the buyer and the seller of the asset agree to share some of the risks and rewards arising from the use of the asset. He noted that although the two situations were different, it could in practice be difficult to distinguish them, which resulted in additional complexities.

Michael Stewart informed that variable consideration is used in the extractive and pharmaceutical industries. In these industries, there could be significant uncertainty about the future prospects of some assets that are bought and sold. Both the buyer and the seller may therefore be hesitant to agree on a fixed price in some of these transactions.

Gary Berchowitz, Partner PwC's Global Corporate Reporting Department considered that variable consideration is introduced when there is uncertainty about the value of the asset exchanged – either because its value depends on future actions, or its value will be derived from the amount of usage of the purchaser. He agreed with Michael Stewart's observation that variable consideration transactions are often used in the pharmaceutical and extractive industries. And mentioned these transactions were also used in the entertainment and media industries (e.g., actors being paid based on how well a theatrical production does). In the pharmaceutical industries, it happens, for example, when a biotech company develops a compound that would have to go through various levels of approval before it can be commercialised. The buyer of this compound, often a larger pharmaceutical company, would generally acquire the compound before all the approvals have been obtained and hence before the compound is ready to be commercialised. Therefore, when the terms of the transactions are agreed upon, there is a lot of uncertainty about the value of the compound. Variable consideration can therefore be introduced and the additional amounts the buyer might have to pay can be quite material – particularly when an acquired compound would make it through to commercialisation. In extractive industries, variable consideration is often structured as royalty payments. And in these cases, the underlying asset (that is, the right to mine) would not be recognised by the purchaser. Accordingly, the purchaser does also not recognise a liability for the variable consideration.

Araceli Mora, EFRAG Academic Panel member, and Professor in Accounting and Finance at the University of Valencia thought that variable consideration normally emerges when there is information asymmetry between the purchaser and the seller. In other words, when the seller knows more about the future performance of the asset than the buyer.

Patrina Buchanan, IASB member, noted that in addition to the examples mentioned by the other panellists, variable consideration is sometimes used in the media industry in relation to broadcasting rights. Also, these transactions can arise in relation to service concession arrangements. For example, an operator of a toll road might have to make variable payments based on the revenue generated by the operator that is related to the particular toll road.

When is/should a liability be recognised for variable consideration that depends on the purchaser's future actions?

Araceli Mora thought that a liability for variable consideration that depends on the purchaser's future actions should be recognised when 1) the past event has taken place; 2) it is expected that the variable payment will be made; and 3) the variable payment can be estimated reliably.

She noted that in relation to the example of the football club, only the additional amount of CU 1 million to be paid as soon as the player has made 25 appearances for the club was relevant to consider. The additional amount of CU 0.2 million when the player is first selected to play for his country would not depend on the purchaser's future actions. For the purchaser to be in a situation where it would have to pay 25% of the gross proceeds from any onward sale of the player before the expiry of the initial contract term, it would have to change the manner it recovers the carrying amount of the asset. This would change from being by using the asset (the asset is accounted for under IAS 38 *Intangible Assets*) to being sold (the asset would be accounted for in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*). In her view, no liability should therefore initially be recognised for this. A liability for this possible additional amount should only be recognised when there would be indications that the player would be sold before the end of the contract term of four years.

For the additional amount to be paid as soon as the player has made 25 appearances, she considered the past event to be when the player would be ready to be used – that is, when the player has been transferred. In reaching this view, she considered that variable consideration should be assessed in the context of the substance of the contract to determine whether the variable consideration is a part of the transaction price or something else. In the example, she considered that the variable consideration was introduced to mitigate the risk of information asymmetry between the purchaser and the seller relating to the value of the player when the player is transferred. It should therefore part of the transaction price.

The next step would then be to assess the likelihood that the CU 1 million would be paid. If it would be considered most likely that the CU 1 million would be paid – not just because of the football club's intention, but because it would be irrational of the football club not to make the player make 25 appearances, a liability related to the variable consideration of CU 1 million should be recognised as the amount could be estimated in a reliable manner.

Under the above circumstances, Araceli Mora considered that there would be a high probability of the seller receiving CU 1 million, so according to IFRS 15 *Revenue from Contracts with Customers,* the seller would recognise a receivable for that amount. It would therefore be sensible that the purchaser should recognise a corresponding liability.

Araceli Mora thought that if it is highly likely that a payment of variable consideration will occur, recognising a liability, including the amount in the cost of the acquired asset, and thereafter in the subsequent amortisation and depreciation expenses, would result in information that is relevant to predict future cash flows. If the measurement could be performed reliably, it would also result in a faithful representation. She also noted that if it is very likely that a variable payment would have to be made; a) recognising a liability and including this in the cost of the acquired asset would result in comparable information; and b) the consideration is similar to a fixed payment. Accordingly, the measurement of the asset should be similar to a situation under which the entire payment would have been fixed. Araceli Mora, however, acknowledged that although a very likely variable payment was similar to a fixed payment, these situations were not identical as some of the risks faced by the purchaser would be shared with the seller when the consideration is variable. She, therefore, thought that it would also be important to have disclosures that could reflect this.

Michael Stewart did not think a liability should be recognised for variable consideration that depends on the purchaser's future actions before the event that triggers the variable consideration occurs. He noted that there is currently mixed practice on when to recognise a liability for variable consideration that depends on the purchaser's future actions. However, most often a purchaser would wait for the triggering events within its control to occur before recognising a liability.

Michael Stewart thought that when considering the past event that would make a liability exist, it would be useful to consider what would be the necessary and sufficient conditions for establishing the liability. In the scenarios considered, the existence of a contract would be necessary for a liability to exist – but it may not be sufficient. When the variable consideration depends on the purchaser's future actions that are within its control, the payment is avoidable, and the purchaser is therefore not under the obligation to make any payments until the relevant actions have been conducted.

Michael Stewart noted, however, that if the purchaser of an asset would have a contractual obligation to perform certain actions and variable consideration would be triggered by the purchaser when performing those actions, a liability for the variable consideration should be recognised when the asset is received. He thus considered that such contractually-obligated actions are not within the purchaser's control; it should be assumed that a purchaser would abide by the terms of a contract.

Unlike, Araceli Mora, Michael Stewart was not in favour of considering the likelihood of variable consideration being trigged when determining whether a liability should be recognised or not. He considered that, from an operational perspective, it would be difficult to determine the probability related to whether variable payments would be triggered. From a conceptual perspective, he thought that either a liability exists, or it does not. The probability was something that ought to be reflected in the measurement.

In response to a question from the audience on whether the economics of a transaction should be taken into account, or the focus should be on the contract, Michael Stewart expressed reservations about overriding the rights and obligations stemming from a contract based on perceptions of the economics. He thought it was important to understand the substance of a transaction, but the starting point for considering the substance would be the rights and obligations arising from the contract.

Gary Berchowitz noted that, in practice, when deciding when to recognise a liability for variable consideration, preparers typically consider: 1) what they are paying for and 2) how to keep the reporting simple. In relation to the latter, recognising a liability before the event triggering the variable consideration occurs, involves a lot of estimation uncertainty, and often preparers are of the view that the cost/benefits of trying to make these estimations were not justified. Normally, if the payment is a milestone type (e.g., when certain approvals have been obtained for a compound acquired by a pharmaceutical company) before the asset (e.g., the compound) is ready for use, the practice is that the preparer would often not recognise a liability for the variable consideration until the variable payment is triggered (e.g., a milestone in the approval process of the compound is achieved). The variable payment is in those cases reflected in the cost of the asset (e.g., the compound). When the asset is ready for use (e.g., the compound has been approved for use), liabilities for variable payments would still only be recognised when the triggering event would occur. In these cases, however, the payments would be recognised as expenses and not included in the cost of the asset.

Gary Berchowitz noted an audit would be easier to conduct if liabilities for variable consideration would only be recognised once the event triggering the variable consideration had occurred. An earlier recognition of the liability would require judgement from the perspective of the preparer and hence also from the auditor.

In his view, however, focusing on when to recognise a liability for variable consideration was a red herring. He thought that the focus should be on the asset acquired and on reflecting the value of this asset. He considered that equity analysts would be interested in knowing about the resource acquired and deployed so that it could be compared/matched with the revenue made. In the example with the football club, he thus considered that the value of the contract with the football player should be reflected. The value of the contract with the football player would not depend on how the payment would be structured, including whether the consideration was fixed or variable. For example, although the variable consideration of CU 1 million would only be triggered after 25 appearances, it could be that the football club could recognise a lot of revenue related to the player in the first 24 matches.

If the focus were to be on reflecting the value of the asset, the obligations to be recognised should equal the fair value of the asset. Part of the obligations incurred would be contractual liabilities that would not depend on the purchaser's future actions and could be a financial liability to be accounted for under IAS 32 and IFRS 9. Another part of the obligations would depend on the purchaser's future actions and could be a different type of liability. Accordingly, for the obligations to match the measurement of the acquired asset, it would be necessary to introduce a hybrid model that would reflect the different types of obligations, or the different attributes of the obligations, incurred in acquiring an asset.

In Gary Berchowitz's view, getting the asset side right and differentiating between the unconditional and conditional obligations would provide a credit analyst with useful information because it would present only the contractual payments that have to be made regardless of the purchaser's future actions.

In response to a question from the audience on whether the economics of a transaction should be taken into account, Gary Berchowitz agreed with Michael Stewart that the contractual rights and obligations should be considered. He thought it would be a slippery slope to start trying to infer rights that do not exist and cannot be enforced. From an audit perspective, it would also be difficult to consider an entity's intentions. Those difficulties were already experienced in relation to IFRS 8 Operating Segments whereby, the 'through the eyes of the management' approach applied made auditing challenging. Starting with the rights and obligations of the contract, should, however, not mean that contractual clauses that would have no substance, but included to achieve a particular accounting outcome, should be considered. Contractual clauses should be disregarded in those exceptional cases.

Serge Pattyn thought that generally a liability for variable consideration that depends on the purchaser's future actions should only be recognised when the event triggering the variable consideration occurs. However, if it is reasonably certain that the event triggering the variable consideration will occur, a liability should be recognised when the preparer receives the related asset.

Serge Pattyn assumed that if it is not reasonably certain that the variable consideration will be triggered, the fixed part of a consideration to be paid for an asset reasonably

reflects the value of the asset. Therefore, under such circumstances, if a liability for the variable payment is also recognised and included in the cost of the acquired asset, the asset will be recorded at a too-high amount. And this results in subsequent amortisation or depreciation expenses being too high and the statement of financial performance not reflecting a profitability that would be indicative of future net cash flows. Also, ratios such as return on invested capital are not correct.

Conversely, if it is reasonably certain that the event triggering the variable consideration will occur, profitability figures and ratios are suitable for predicting future profitability when a liability for the variable consideration is recognised and the amount included in the initial cost of the asset and subsequent amortisation and depreciation expenses. In relation to the example with the football club, and based on how many appearances players had for top football clubs, he considered that there was a reasonable chance that the variable consideration would be paid.

Although Serge Pattyn considered that a liability for variable consideration should be recognised when it is reasonably certain that the event triggering the variable consideration will occur, he was not in favour of having to consider probabilities for different events to happen in the measurement of a liability for variable consideration.

Views of the audience

As shown in Table 1, in response to a polling question on when a liability should be recognised for variable consideration that depends on the purchaser's future actions, the audience provided their views as follows :

Table 1: What is your view regarding the liability recognition in a transaction involving variable consideration that depends on the purchaser's future actions?

A liability for the variable consideration should be recognised 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.	63.16%
A liability for variable consideration should be recognised when the purchaser performs the actions that trigger the variable consideration.	10.53%
A liability/several liabilities (with a distinction between the different types of liabilities), should be recognised when the purchaser obtains control of the asset acquired. The total amount of these liabilities should mirror the fair value of the asset acquired.	15.79%
Other	10.53%

When does a purchaser not have a practical ability to avoid taking an action that would trigger variable consideration?

The DP notes that one of the criteria of the IASB's Conceptual Framework for when a liability exists is that the entity has an obligation. The Conceptual Framework states that an obligation is a duty or responsibility that an entity has no practical ability to avoid. The DP included a non-exhaustive list of possible ways in which the reference to 'no practical ability to avoid' could be interpreted. Panellists discussed when a purchaser has no practical ability to avoid performing an action that would trigger variable consideration.

Araceli Mora thought that there could be many indicators that an entity would have no practical ability to avoid taking an action that would trigger variable consideration. All of the following indicators listed in the DP could be indicators, although some would be stronger than others:

- when avoiding the variable payment would mean that the purchaser would have to cease its activities
- when avoiding the variable payment would have a significant unfavourable economic impact on the entity
- avoiding the variable payment would have a significant unfavourable economic impact in the context of the acquired asset
- avoiding the variable payment would result in using an acquired asset in a manner that would not reflect the economic purpose of acquiring the asset
- avoiding the variable payment would have marginal economically unfavourable consequences for the entity.

Serge Pattyn thought that the relevant assessment of when something would not be practical to avoid would depend on the facts and circumstances, so he could not say which of the criteria he agreed most with.

Michael Stewart was not in favour of introducing thresholds for the recognition of a liability that depends on the purchaser's future actions. He thought that the characteristics of an arrangement should determine whether an entity would have a liability or not – and not the degree of how economically unfavourable it would be for an entity not to trigger the variable payments. If he had to consider the degree of being economically unfavourable that would make something practically unavoidable, he would set a high threshold. This would be more in the direction that something would be practically unavoidable if it would mean that the purchaser would have to cease its activity than it would be practically unavoidable because avoiding the variable payments would have marginal economically unfavourable consequences for the entity.

Gary Berchowitz thought that instead of considering the existence of a liability as a binary question, it would be more useful to explain that there are different types of obligations. There are those obligations that depend on the entity's future actions and those that do not. Making this distinction would take the pressure off from having to consider when variable payments are practically unavoidable. Considering when something is practically unavoidable might also be difficult to assess in some circumstances from an audit perspective if it involves judgement of the preparer of the financial statements on whether or not performing an action would result in a significant unfavourable economic impact to the purchaser. These judgements could also result in diversity in practice. If he had to pick a threshold, he would, unlike Michael Stewart, set this relatively low. He thought that if an asset is acquired, it does not make sense economically not to use that asset, because if the purchaser is not going to use the asset, why would the purchaser have entered into the commercial transaction?

Views of the audience

As shown in Table 2, in response to a polling question on when a purchaser does not have a practical ability to avoid taking the actions that would trigger a variable payment, the audience provided their views as follows:

Table 2: Which criteria do you consider to be the most appropriate to assess whether a purchaser does not have the practical ability to avoid the variable payment?

When avoiding the variable payment would mean that the purchaser would have to cease its activities	10.00%
When avoiding the variable payment would have a significant unfavourable economic impact on the entity	30.00%
When avoiding the variable payment would have a significant unfavourable economic impact in the context of the acquired asset	0.00%
When avoiding the variable payment would result in using an acquired asset in a manner that would not reflect the economic purpose of acquiring the asset	30.00%
When avoiding the variable payment would have marginal economically unfavourable consequences for the entity	20.00%
Other	10.00%

Complexities and cost of alternatives for requirements

Michael Stewart noted that under the assumption that disclosures would be provided on variable consideration, he did not think there would be a big difference in the costs for preparers in recognising a liability for variable consideration before the event triggering the variable consideration occurs, compared with only recognising the liability after the event triggering the variable consideration has occurred. He explained that for internal purposes (i.e., for budgeting and cash management purposes), the management needs to make some assessments already regarding the probability of future cash outflows. Also, if useful disclosures were to be provided, information on the variability, the risks, time period, and the factors on which the variability depends would have to be disclosed.

Gary Berchowitz thought that the approach of waiting to recognise a liability until the event triggering the variable consideration has occurred is currently used by most preparers, and it is the easiest and least costly approach. He assessed that providing qualitative disclosures on variable consideration would also be relatively uncostly. He thought the costliest option would be one under which judgement is needed to assess whether a liability should be recognised or not. For example, if recognition depends on whether the purchaser has the practical ability to avoid making the action that triggers the variable consideration. Making such an assessment is costly both for the preparer and for the auditor.

Gary Berchowitz acknowledged that his proposal of recognising and differentiating different types of obligations might also become complex as the measurement of the liability related to variable consideration that depends on the purchaser's future actions could be complex. However, he thought that there could be ways to reduce those costs which would involve decreasing the amount of effort to estimate the initial measurement and truing those estimates up in the subsequent measurement as more information is obtained.

Serge Pattyn did not think there would be any issues for users in relation to understanding the figures reported in relation to variable consideration under the different alternatives. However, for users to understand the issues related to variable consideration, it would be essential that good disclosures are provided to make the arrangement transparent.

Guidance in the Conceptual Framework for Financial Reporting

Patrina Buchanan considered that the changes made to the IASB's Conceptual Framework in 2018 provide a good starting point for the discussion on when to recognise a liability for variable consideration that depends on the purchaser's future actions. She considered that the expanded guidance on the definitions of an asset and a liability together with guidance on when to recognise these are helpful to consider.

Though she noted the Conceptual Framework is not designed to provide all the answers, she emphasised the Conceptual Framework is focusing on the rights and obligations within a transaction. She did not think obligations could be considered without also looking at the rights that were received or would be received in the future in exchange for fixed and/or variable consideration. Hence, in her view, it should be assessed whether the purchaser has received all the rights or would potentially receive additional rights in the future. In the example with the football club, it may be the case that all the rights have been received when the player has been transferred. The right transferred is a right to use the player to play in club matches. In other cases, for example, in some pharmaceutical contracts, it could be that the purchaser obtains two separate rights—it might first receive a right to develop a drug, and then later receive a right to sell the developed drug. In that case, the purchaser would receive different rights at different points in time. The purchaser would consider whether to recognise a liability only for amounts payable for those rights that have been received; it would not do so for rights not yet received. Therefore, if variable consideration encompasses payments for rights to be received in the future, no liability should be recognised for this consideration before those rights are received. On the other hand, if all the rights have been received, the variable consideration would then relate to those rights. In such a case, the purchaser has already obtained economic benefits and, as a result, will or may have to transfer an economic resource that it would not otherwise have had to transfer (paragraph 4.43 of the Conceptual Framework). Accordingly, the transfer of the rights is the relevant past event to consider.

On the question of whether the purchaser has no practical ability to avoid taking the actions that would trigger the variable consideration, she stated that the Conceptual Framework does not provide a definitive answer on this aspect. Hence, the IASB would need to develop requirements regarding 'no practical ability to avoid an action' if it were to undertake a project involving variable consideration. Her personal view on this was that requirements in that respect should not be complex, so any threshold should either be very high or very low. She also stated that for exchange transactions on market terms, she would likely go for an approach where it could generally be assumed that the purchaser would have no practical ability to avoid paying the variable consideration. She thought that the parties to a transaction involving variable consideration would almost always know what they are signing up to. In the football club example, one could thus assume that the football player was going to make at least 25 appearances. If there would be some unusual or extreme terms, then there could be instances where the purchaser would have the practical ability to avoid triggering the variable consideration. Also, if measurement uncertainty would be high, there could be situations where a liability for variable consideration would exist, but it should not be recognised because of the extent of measurement uncertainty.

Araceli Mora agreed with Patrina Buchanan on the interpretation of the guidance in the Conceptual Framework. She did not think the issues with variable consideration had arisen because of the Conceptual Framework, but because of the inconsistencies among existing IFRS Standards. This made it difficult to apply requirements by analogy. She thought it would be useful to know the arguments for the differences in the current standards. She thought IFRS 15 would be the best Standard to use to develop accounting practice by analogy. This would mean that a liability should be recognised for variable consideration that would depend on the purchaser's future actions, if the requirements, as previously mentioned, would be met. IFRS 16 *Leases* could not be used as it was internally inconsistent.

The approach to standard setting

Patrina Buchanan thought that, in her view, if the IASB were to undertake standard-setting activity, it should consider the issue narrowly and be very disciplined about the scope. If the IASB would think about the topic too widely, it could end with endless theoretical debates. The starting point should be to consult with the investor community to understand where improvements are needed. The IASB should then only focus on those identified gaps. This might mean that existing requirements on variable consideration would not be reconsidered, such as the requirements in IFRS 16. Patrina Buchanan thought that variable consideration or variability in payments is a consideration in some of the projects on the IASB's current work plan. In the current project on IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, some of the thinking on the definition of a liability would be considered; there is also the project on financial liabilities with characteristics of equity.

Patrina Buchanan noted that when filling gaps by introducing new requirements on variable consideration, it would be important to ensure that any new requirements would not create problems when interacting with other requirements or standards.

Patrina Buchanan agreed with Araceli Mora that the explanation in the basis for conclusions regarding the requirements on variable consideration in IFRS 16 was insufficiently clear. She noted that if the revision of the IASB's Conceptual Framework had been finalised before IFRS 16 was developed, it would have been possible for the IASB to better articulate the reasons for the requirements. She noted that the fact that some entities have thousands of leases with variable payments was an important consideration for the IASB when developing IFRS 16. That, together with input from users, made, in her view, the IASB reach the consensus that it would not require a liability to be recognised for variable payments that would depend on, for example, future sales. Had she been an IASB member when IFRS 16 was developed, she would probably have concluded that if variable consideration would depend on, for example, future sales, a liability for the variable consideration existed at the commencement date of a lease. However, arguments around measurement uncertainty may have also swayed her to the view that the liability should not be recognised.

In response to a question from the audience asking whether the likelihood of a transfer was not a question of measurement rather than a question of recognition, as suggested by a panellist, Patrina Buchanan replied that she would not consider probability when assessing the existence of an obligation. When assessing the notion of 'no practical ability to avoid' she would not set a high probability threshold. However, assessments of the probability of a transfer could affect whether an obligation should be recognised. High measurement uncertainty could be a reason for not requiring liabilities to be recognised. In the example with the football club, it could thus be considered whether an obligation to pay 25% of the gross proceeds from any onward sale of the player before the expiry of the initial contract term could be sufficiently reliably measured, particularly if the initial plan of the football club would be to keep the player for four years. In such a case, she doubted that a very uncertain estimate would provide useful information to investors.

2. Panel discussion of the measurement of the acquired asset issue

Claes Norberg, Chair BusinessEurope Sounding Board and EFRAG Administrative Board member, Director of Accountancy at the Confederation of Swedish Enterprise, introduced and moderated the debate. He highlighted that, unlike the discussion on the liability recognition issue, the question of whether – and if so when – to update cost to reflect changes in variable consideration was also relevant for variable consideration that would not depend on the purchaser's future actions.

Panellists then discussed:

- how are entities currently accounting for changes in estimates of variable consideration?
- the definition of 'cost' and guidance in the Conceptual Framework
- whether, and if so when, should the cost of an asset be updated to reflect changes in a liability for variable consideration?
- costs and complexities of different alternatives for requirements

How are entities currently accounting for changes in estimates of variable consideration?

Gary Berchowitz explained that one of the factors determining how entities currently account for changes in estimates in variable consideration was what the payment was made for. The practice in the pharmaceutical sector was that the purchaser of a compound would normally only recognise a liability for variable consideration that depends on the purchaser's future actions when the event triggering the variable consideration happens. If this would happen before the compound is ready to be used, the payment would generally be capitalised as the cost would often be related to the future cash-generating capacity of the asset. After the compound would be ready for use, variable payments would often have the characteristics of royalty payments, related to the past use of the compound and hence these payments are often recognised as expenses.

Michael Stewart added that when variable payments are made when milestones are achieved in the development, they would often be linked to the future economic benefits that will result from the asset acquired. Therefore, such payments were often included in the cost of the asset. On the other hand, when the variable payments reflect a sharing of the results of the asset after it has started being used, they are commonly seen as an operating expense.

The definition of ‘cost’ and guidance in the Conceptual Framework

Araceli Mora thought the Conceptual Framework provided good directions on when the cost of an asset should be updated to reflect changes in estimates of variable consideration – and when it should not. She thought it was important to distinguish between:

(a) changes in the expected performance or expected cash flow of the acquired asset (the quality of the asset); or

(b) changes in the estimate of variable consideration of the transaction price (which could be linked to the quality of the asset – or other factors).

She thought that discussion on the difference between these was missing from the DP.

In the case of changes in the expected cash flows from an asset, she noted that these should not be reflected in an asset measured at cost – except if there would be an impairment loss. In the case there was a change in the transaction price this should, on the other hand, affect the cost of an asset. Therefore, a change in variable consideration that would be part of the transaction price should update the cost measurement of the acquired asset.

When talking about variable consideration, the issue was, however, how to account for a change in the transaction price. As the transaction price is part of the historical cost, changes in the transaction price should be reflected in the cost of an asset.

In the example with the football club, if it was first estimated that the football player would have 25 appearances, but the football player would then be injured, so the 25 appearances would no longer be expected, there would likely be two effects. Firstly, there could be an impairment loss if it was no longer expected that the cost of the player could be recovered. Secondly, there would be a reduction in the transaction price of CU 1 million. The cost of the asset should accordingly be updated to reflect this change.

On the other hand, if the player would be much better than expected, the cost should not be updated as there would be no additional amounts to pay (beyond the payment after the 25 appearances). Also, the additional expected future cash flows should not affect the measurement at historical cost.

Araceli Mora also noted that it was very clear from IFRS 15 *Revenue from Contracts with Customers*, that changes in estimates of variable consideration were changes in the transaction price, which is part of the historical cost of an asset.

In response to a question from the audience on whether her approach was similar to the approach required by IFRS 3 *Business Combinations* on contingent consideration, she replied that it was not. It was similar to the approach required in IFRS 15 for the seller.

In response to a question from the audience on how to distinguish between changes in the expected cash flows of an acquired asset and changes in the estimate of variable consideration, she replied that it could depend on the case how easy it would be to make the distinction. She thought that it should be possible to make the distinction as the seller, when following the requirements of IFRS 15 had to know what would relate to the transaction price.

Unlike Araceli Mora, **Patrina Buchanan** thought the Conceptual Framework gave no clear direction on whether changes in estimates of variable consideration should be reflected in the cost of the acquired asset or not. If the IASB were to develop requirements on this, she could see an approach that would consider the rights acquired. Under such an approach, the question would be whether anything has changed in terms of the bundle of rights embedded in the asset acquired when an event triggering the variable payment occurs. For example, if an entity would have to pay an additional amount for a compound when a milestone in the approval process would be achieved – would the achievement of that milestone mean that there are new or different rights embodied in the asset acquired that were not initially recognised? If that would be the case, it could make sense to adjust the cost.

From a cost-benefit perspective, she also thought it should be considered whether the liability should be remeasured at all. It could depend on the initial measurement. If an exchange transaction is at market terms, then the transaction price on that date could be said to represent the exchange transaction of the asset and the liability exchanged at that date, and, for cost-benefit reasons, it might not be necessary to update the measurement. If the liability measurement is updated, it could be argued that changes in a liability for variable consideration occur as a result of changes in the reporting period, which should not affect the initial measurement of the asset. On the other hand, there could be potentially good arguments for updating the measurement of the asset, if there is a change in what you have really paid for the asset. The requirements in IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* and IFRS 16, for payments that are inflation-linked, reflect the thinking that if a variable amount was included in the initial cost based on an estimation, that estimate should be updated when a better estimate could be made. However, she could also see the argument that the original cost estimate could be viewed as the best cost estimate reflecting the exchange transaction at the transaction date.

Whether, and if so when, should the cost of an asset be updated to reflect changes in a liability for variable consideration?

Serge Pattyn thought that generally the cost of an acquired asset should be updated to reflect changes in the liability for variable consideration, but there could be circumstances where it should not. Serge Pattyn thought that if a purchaser would have to pay an additional amount for an asset because the asset would be more successful and profitable than initially expected, this should be reflected in the cost of the asset, as updating the cost would reflect what had been paid for the asset – the invested amount. An exception would be when the variable consideration is equivalent to the purchaser having to pay part of the sales price of an item to the seller. In those cases, the payment would relate to past income of the entity and would not be related to future cash flows the asset would be able to generate. For example, in his view, if an entity is selling a product for CU 10 per unit and will have to pay CU 1 to the seller for each unit it sells in excess of 10 000 units. If that would be the case, the CU 1 should not be added to the cost of the asset.

In response to a question from the audience on whether it would be better to reflect changes in a liability for variable consideration in the cost of the asset in order to avoid big fluctuations in profit or loss, Serge Pattyn replied that it would make more sense to include the changes in the cost. He did not think it would result in useful information to have big fluctuations in profit or loss as a result of a recurring revision of estimates of variable consideration.

Positing how an equity analyst would want to view performance, **Gary Berchowitz** asked Serge Pattyn whether it would not make sense to adjust retrospectively to avoid depicting a decline in profit margins due to higher amortisation and depreciation expenses. He noted that in the example with the football club, it could be that the club had earned a lot of money because of the player before the player had made 25 appearances. If a liability for the variable consideration related to the 25 appearances would only be recognised after the player has made 25 appearances, the profit for the periods following the 25 appearances would be lower than before the 25 appearances because of the increase in the amortisation expenses following from the upward adjustment in the cost. This decrease in profitability would have nothing to do with any poor business decisions. Therefore, in order for trend information to be as useful as possible and have predictive value, Gary Berchowitz suggested a retrospective adjustment, so that part of the adjustment would be reflected in retained earnings and the financial statements would reflect the profitability of prior periods if the cost price at that time had included the additional variable consideration.

Serge Pattyn agreed that the retrospective adjustment was something that should be considered when preparing requirements on the issue.

Michael Stewart favoured Alternative 3 d) of the DP – that is to update the cost of the asset to the extent the variability is linked to the initial quality of the asset. He noted that there were different reasons for introducing variable consideration. It could be introduced because there is uncertainty associated with the asset, or it could be to share risks and rewards from the activity in which the asset would subsequently be used. It would require judgement to determine the substance of a transaction and what the rights and obligations would be. To the extent the purpose was to share risks and rewards, he did not think it would be justified to add the resulting payments to the cost of the asset. He only thought it would be relevant to update the cost of the asset if the variable payment was related to the initial quality of the asset. The term 'initial' was important. He noted that the further away in time one would move from the transaction date, the further one would move from the original quality of the asset as future cash flows could be impacted by so many factors such as the general economic development, changes in market prices, and the use of other inputs by the purchaser to generate economic benefits. In the football club example, the performance of one player could be affected by the other players on the team. He did not think it would be useful to add costs to an asset that had nothing to do with the asset but could be a result of the economic environment or the manner the asset was used by the purchaser.

An audience member noted that the discussion seemed to focus on additional amounts that were to be paid and questioned how variable consideration where the purchaser would receive money back – such as trade discounts – should be accounted for. In response, Michael Stewart replied that for trade discounts, requirements existed, however, more generally, requirements would also have to take this scenario into account. However, he added that most often, variable consideration was about paying an additional amount and requirements exist on how to account for trade discounts.

Michael Fechner noted that IFRS 3 considered both situations under which the purchaser would have to pay an additional amount as well as situations under which the purchaser would receive money back from the seller – although it stated that it was most often the case that the purchaser would have to pay an additional amount. He, therefore, thought it would also be relevant to consider when the purchaser should recognise a receivable if the variable consideration would depend on the purchaser's future actions. Perhaps it should then also be considered whether the purchaser's intention would be to do an action that would result in payments from the seller.

Gary Berchowitz was of the view that the cost of the acquired asset should only be updated to the extent that the changes in the estimate of a liability for variable consideration is related to future benefits to be derived from the asset. He agreed with the view that the initial measurement of the asset would reflect what would be known at the time of the transaction. After the initial measurement, you could get better information and things could change. Whether these changes should be included in the measurement of the cost or in profit or loss, should, however, depend on whether the benefits related to the change would already have been received or would be received in the future. In the example with the football club, if it was initially estimated that a player would not make 25 appearances, but after 20 appearances, that estimate was revised. The price for the player would then go up by CU 1 million. However, some of the benefits that would be received for that additional CU 1 million would already have been received in the first 20 appearances of the player – and some of the benefits are going to be received in the future. Accordingly, not the entire amount of CU 1 million should be added to the cost of the asset. He thought that this approach also reflected the thinking in the basis for conclusions of IFRIC 1, although the final requirements included in IFRIC 1 were different for other reasons.

Gary Berchowitz found that Michael Stewart's view on only updating the cost if the variable payments related to the initial quality of the asset could be supported by the requirements in IFRS 3. IFRS 3 was based on the thinking that cost should only be updated to reflect the initial price of the asset. So only changes that relate to the initial condition of the asset could be reflected in cost and changes that would happen after one year were presumed to be related to how the entity was running the business and other factors. He thought, however, that it was less important to consider the reason for the change in the price that had to be paid for an asset, including whether it was related to the initial quality of an asset or not. It was more important to reflect what eventually had to be paid for the asset – the amount invested.

Costs and complexities of different alternatives for requirements

Michael Stewart assessed that there would be additional costs with an approach under which changes in estimates of variable consideration would be reflected in the cost of the acquired asset as it could result in an increased risk of impairment – and hence there could be additional costs with performing the impairment testing. On the other hand, if all of the adjustments are being taken to profit or loss, then the preparer may find themselves having to explain these figures appearing in profit or loss. The impact of these amounts on the profits for an entity could result in the entity preparing non-GAAP measures in order to explain how the financial results are affected. So, there would be costs and complexities associated with all the alternatives – but they would be different for the various alternatives.

Gary Berchowitz added that the complexities were higher the earlier a liability for variable consideration would be recognised. If it would only be recognised when the event triggering the variable consideration had occurred, there would be no estimation uncertainty. He also noted that his suggested approach to update the measurement of cost under which an allocation would be made between benefits already obtained and future benefits would not be the simplest solution. It would be difficult to get the split right. However, it would be less risky to audit this split than, for example, assessing the likelihood of different occurrences, if the likelihood of something would happen would be introduced as a recognition criterion for a liability for variable consideration as suggested by a couple of other panellists.

Serge Pattyn noted that updating the cost could mean that it would be necessary to revise amortisations and depreciations of an asset and perhaps an impairment loss would be incurred. However, he thought that it would seldom be the case that variable consideration would be structured in a manner that would result in the purchaser having to recognise an impairment loss if the additional amount to be paid would be added to the cost of the asset – although the situation could occur.

Patrina Buchanan commented on the standard-setting complexities. She noted that the discussion had highlighted the various considerations standard setters would face when trying to deal with the issue. In relation to when to update the measurement at cost, the nature of the payment might have to be considered, and then it had to be assessed if it was possible to draw a line for when the measurement should be updated and when it should not – would some cases be different from others? To limit the complexities, she thought it was important for standard setters to stay narrowly focused on, for example, items of PPE and intangibles acquired for variable consideration. There would still be a variety of different types of transactions in the form of different types of rights and different forms of consideration. A standard setter would not only have to consider the different types of rights and obligations, but also the recognition requirements for those, measurement uncertainty and also cost/benefit considerations. In relation to measurement, it was necessary to consider both initial and subsequent measurement. Then when developing new requirements, it was also necessary to ensure that these would work well with other existing requirements on PPE and intangibles.

In response to a question from the audience on whether it would not also be relevant to consider IAS 40 Investment Property in addition to IAS 16 Property, Plant and Equipment and IAS 38, Patrina Buchanan replied that it would. IAS 40 required initial measurement at cost, and if the subsequent measurement would also be at cost, the requirements in IAS 16 would apply. Therefore, any new requirements on when to update the cost of an acquired item of PPE would also apply to investment properties measured at cost.

Gary Berchowitz added that if a liability for variable consideration should be recognised before the amount would be known, it should be considered what the best measurement would be. He questioned that fair value would always be the best measurement basis. He thought that the guidance included in IFRS 15 for when to use an expected amount versus the most likely amount could also be useful in relation to the measurement of a liability for variable consideration. So, in his view, the initial and subsequent measurement of the liability was also something that had to be considered when preparing requirements on the topic.

He agreed with Patrina Buchanan that it was important to stay narrowly focused, otherwise there was a high chance that a project would not progress. He had been involved with the IFRS Interpretations Committee's work on variable consideration in service concession arrangement, and even in a project with such a narrow scope, it had not been possible to arrive at an answer. It would be even more complicated if variable consideration in relation to business combinations and leases were also to be considered in a project.

Views of the audience

As shown in Table 3, in response to a polling question on when the cost of an acquired asset should be updated to reflect changes in estimates of variable consideration, the audience provided their views as follows:

Table 3: When should the cost of an acquired asset be updated to reflect changes in estimates of variable consideration?

Cost of the asset should never be updated		20.00%
Cost of the asset should always be updated		20.00%
Cost of the asset should be updated under some circumstances		60.00%
• When estimates of variable consideration are included in the asset's cost at initial recognition;	16.67%	
• When change in estimates of variable consideration takes place before the asset is ready for its intended use;	0.00%	
• When variable payments are associated with future economic benefits to be derived from the asset;	50.00%	
• When variable consideration is linked to the initial quality of the asset. o Other	16.67%	
• Other	16.67%	

3. Concluding remarks

In his concluding remarks, **Michael Stewart** noted that the issue was challenging and had been so for many years. He, therefore, welcomed the DP. He thought that it was an area that requires judgement in order to assess the rights and obligations arising from a transaction and, thereafter, to determine the substance of a transaction. He thought it was important to distinguish between variable consideration that was purely related to an asset and variable consideration related to an activity in which an asset is being used in a risk-sharing kind of arrangement.

Gary Berchowitz observed that the IASB had had the topic on its agenda but had had to deal with more urgent issues. He thought that the current discussion on the topic would help the IASB if it were to take on the project at a later stage. The IASB would then have something it could build its discussions on.

Serge Pattyn stated that as a user, he was interested in knowing how much had been invested, in which assets and how much profit an entity was deriving from those assets. He thought that when developing requirements on variable consideration, the focus should be on providing relevant and reliable information on these aspects.

Araceli Mora did not think the issue could be solved by standard setters as it was an area requiring a lot of judgement. It was accordingly mostly an issue for preparers and auditors.

Patrina Buchanan explained that following the IASB's Third Agenda Consultation, the IASB had not received a mandate from its stakeholders to proceed with its project on variable consideration. Stakeholders had found that there were more pressing issues the IASB should prioritise. The debate following EFRAG's Discussion Paper would, however, be valuable to the IASB not only if the IASB were to include a topic on variable consideration on its work plan in the future, but also for some of the topics currently on the IASB's work plan. The issue of variable consideration could come up as part of the IASB's projects on intangibles and IAS 37. In relation to the project on IAS 37, some of the discussion on the definition of liability would naturally feed into that project. It could be the case that stakeholders in the future would ask the IASB to include a project on variable consideration on its work plan.

Concluding remarks

Chiara Del Prete, EFRAG SR TEG Chairwoman and former EFRAG FR TEG Chairwoman, summarised the panel discussions. She noted that the discussions had confirmed that there was divergence in practice on how to account for variable consideration and there were differing views on how requirements should be in the area. Based on the discussions EFRAG FR TEG had had on the issue, she recommended the IASB to clearly scope any project it would initiate on variable consideration.