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Variable and Contingent Consideration: An Initial Conceptual Exploration

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Views expressed are personal and not necessarily those of the FRC.

Why a project on Variable and Contingent Consideration?

- IFRS address various examples of V&C transactions

BUT

- Underlying principles are unclear
  - Are they consistent?
  - What principles would be useful in framing future accounting standards?
- New Conceptual Framework
- Topic in IASB's Research Pipeline

Scope of today's discussion

- Accounting by the purchaser
- Exclude time value of money
- Transactions on market terms
- Assets acquired are reported at cost
- Consideration is payable in cash

The issues

Initial recognition

- What asset(s) are acquired?
- What liabilities are assumed?
- Should assets and liabilities be recognised?

Subsequent remeasurement

- How should changes in the amount of the liability be reported?
  - Adjustment to the amount of the asset?
  - Income or expense?

Probable answers: ‘it depends’…but on what?

Extracts from the Conceptual Framework assets

- An asset is a present economic resource controlled by the entity as a result of past events.
- An economic resource is a right that has the potential to produce economic benefits.
- …an entity may control a proportionate share in a property…in such cases, the entity's asset is the share in the property, which it controls, not the rights arising from ownership of the entire property, which it does not control.

Asset acquired

- Entire item
  - and a liability for variable and contingent consideration
- Partial interest
  - and no liability for variable and contingent consideration, but…
  - perhaps also other rights or obligations

Examples

- Foreign currency
- Racehorse
- Publisher

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The Conceptual Framework on liabilities

- An obligation
- No practical ability to avoid the obligation*
- Obligation must be to transfer an economic resource
- Obligation must exist as a result of past events*
  - Economic benefits have been obtained or action taken, that results in a new obligation to transfer an economic resource

All the above four conditions must be met

** These conditions seem particularly relevant to V&C, but are (sometimes) quite tricky to interpret.*

Extracts from the Conceptual Framework liabilities

- In some situations, an entity's [obligation] is conditional on a particular future action that the entity itself may take. Such actions could include operating a particular business …or exercising particular options within a contract. In such situations, the entity has an obligation if it has no practical ability to avoid taking that action.
- …neither an intention to make a transfer, nor a high likelihood of a transfer, is sufficient reason for concluding that the entity has no practical ability to avoid a transfer.

Recognition in the Conceptual Framework

- A faithful representation of assets, liabilities and any related income and expenses or changes in equity
- Measurement uncertainty may make it questionable whether a faithful representation can be achieved
  - May be a factor in many V&C transactions
- Initial recognition of a transaction on market terms generally does not give rise to income or expenses(?)
  - Only items that meet the definition of an element are recognised (but not all of them)

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Changes in the amount of the liability

- Adjustment to the cost of the asset?
- Income or expenses?

Two views of historical cost

- What if liability is increased:
  - To a greater amount than that expected at the time of the transaction
  - As a result of an event that does not indicate any increase in the value of the asset

Two views:

a) Historical cost represents the extent to which the cost of an asset is recoverable

b) Historical cost is a record of the costs actually incurred

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A hint from the Conceptual Framework?

- Normally, if an entity acquired an asset in a recent transaction on market terms, the entity expects that the asset will provide sufficient economic benefits that the entity will at least recover the cost of the asset....Hence, measuring an asset... at historical cost...provides relevant information about both the asset ...and the price of the transaction that gave rise to that asset...

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Questions for discussion by ASAF

1. Do you agree that it is worth exploring the conceptual basis for dealing with transactions involving variable and contingent consideration?
2. Do you agree with the analysis presented? Within the limited scope of the paper, is anything missing?
3. How is the project best taken forward?