EFRAG TEG
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Variable and Contingent Consideration: towards a conceptual analysis

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

Why a project on Variable and Contingent Consideration?

- IFRS address various examples of V&C transactions

BUT

- Principles underlying existing standards are unclear
  - are they consistent?
  - what principles would be useful in framing future accounting standards?
  - should existing IFRSs be revised?
- New Conceptual Framework
- Topic in IASB's Research Pipeline

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Scope of today's paper

- Accounting by the purchaser
- Exclude time value of money
- Transactions on market terms
- Assets acquired are reported at historical cost

The issues

- What asset(s) are acquired?
- What liability/(liabilities) are assumed
- Should the asset(s) & liability/(liabilities) be recognised?
- How should changes in the amount of the liability be reported?

Examples

- Truck purchased in foreign currency
  - or for a bet on a horserace
- Publisher acquires all rights to a novel
  - but selling more than 5,000 copies requires additional payments
- Racehorse (‘Pegasus’) acquired
  - but seller retains rights to a share of winnings from a future horserace

What asset(s) are acquired?

- Entire resource
  - Entire rights to a novel
  - A ‘whole’ racehorse
- Partial interest
  - And an option (eg to publish further copies, on further payment)

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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.

Assets acquired in the examples

Truck

- Asset acquired is a truck.

Publisher

- Assets acquired are:
  - Unconditional right to publish and sell 5,000 copies
  - An option to sell more on further payment

Racehorse

- Asset acquired is an interest in a racehorse

Question for EFRAG TEG (1)

- Do you agree that the Framework requires that identifying the assets obtained from a transaction involving variable or contingent consideration requires analysis of the rights obtained, which may sometimes be less than those that would be obtained from an outright cash purchase?

- Are you comfortable with that conclusion?

The Conceptual Framework on liabilities

- An obligation that the entity has no practical ability to avoid
- Obligation is to transfer an economic resource
- A present obligation that arises from past events

An entity has a liability only if all three of these are met.

Extracts from the Conceptual Framework ‘practical ability to avoid’

- 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.

‘No practical ability to avoid’ in the examples

Truck

- Criterion met—purchaser must pay, albeit in foreign currency

Publisher

- Criterion not met—publisher is under no obligation to publish any copies, and so can avoid any variable payment

Racehorse

- Criterion met—contractual conditions require that Pegasus run in the Derby

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Extracts from the Conceptual Framework 'past events'

A present obligation exists as a result of past events only if:

(a) the entity has already obtained economic benefits or taken an action; and

(b) as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.

The economic benefits obtained could include, for example, goods or services. (paragraphs 4.43, 4.44)

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‘Past events’ in the examples

Truck

- Criterion met—purchaser has received a truck

Publisher

- Criterion not met—until publisher sells copies that trigger additional payments

Racehorse

- Criterion not met—because purchaser has not acquired an entire interest in future winnings

Question for EFRAG TEG (2)

- Do you agree that the principles identified in the Framework are helpful in identifying the liabilities that arise from a transaction involving variable or contingent consideration, and are you comfortable with the conclusions they suggest?

- Do you agree that further clarification of the ‘no practical ability to avoid’ criterion would be helpful?

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Recognition: some key points

- Recognition of assets and/or liabilities should provide a faithful representation, not only of the assets and liabilities, but also of any related income, expenses or changes in equity (Framework paragraph 5.18).
- Measurement uncertainty may be so high that it would be questionable whether an estimate would provide a sufficiently faithful representation of the asset or liability or any resulting income, expenses or changes in equity (Framework paragraph 5.20).

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Recognition in the examples

Truck

- Recognise

Publisher

- Recognise assets and liabilities, if reliably measurable
- If not, as a pragmatic approach recognise unconditional rights at the amount of the fixed payment

Racehorse

- Recognise interest in racehorse at the amount of the fixed payment

Question for EFRAG TEG (3)

- Do you agree that the purchaser should account for the asset(s) acquired in a transaction involving variable and contingent consideration by reporting asset(s) at the amount of the fixed consideration payable if the variable consideration does not meet the definition or recognition criteria for a liability?

- Can you suggest any alternative to the pragmatic solution of treating the amount of the fixed consideration as relating only to the unconditional rights obtained?

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Changes in the amount of the liability (other than 'options to purchase more')

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

Two rationales

- Report all changes as adjustments to the historical cost of the asset acquired
- Report changes as adjustments to the historical cost of the asset acquired only where the value of the asset is increased
  - eg variable consideration linked to gold price would adjust the historical cost if the transaction were for the purchase of a gold mine, but not if it were for the acquisition of an aircraft

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Question for EFRAG TEG (4)

- Do you believe that, conceptually, all changes in a liability for variable and contingent consideration (other than ‘options to purchase more’) should be accounted for as changes in the reported amount of the related asset or that only those changes that evidence changes in the value of the asset should be so treated?
- Do you agree that further consensus on the concepts underlying historical cost would be useful?

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