Variable and contingent consideration: towards a conceptual analysis

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Background

This paper invites EFRAG TEG participants to contribute to the FRC's research on 'variable and contingent consideration'. The aim of the project is to identify the extent to which the IASB's 'Conceptual Framework for Financial Reporting' can assist in the resolution of issues relating to such transactions in the development of future accounting standards.

Some restrictions on the scope of the project are noted in Section 1 below. These might be reconsidered as the project progresses.

There are also issues that must be addressed before the project can be credibly regarded as complete. These include, but may not be limited to, the following.

(a) This paper considers only accounting by the purchaser. What are the implications for accounting by the seller? Is the accounting symmetrical, and, if not, why not?

(b) What if the variation in the consideration triggers the purchaser's right to a refund of the amount paid at inception rather than, as addressed in this paper, an obligation on the purchaser to pay more?

(c) How would the accounting change if the assets and liabilities arising from the transaction were reported at fair value rather than historical cost?

Reaching consensus on the issues raised in the paper will probably assist in addressing these questions.

In a number of instances, the rationale of the paper is explained by examples. It is intended that as the project is taken forward the principles will be tested against many more examples.

The outcome of the project has not been decided. It might be, for example, a working paper to be shared among standard-setters, or a publication.

Structure of this paper

This paper is structured as follows:

- Section 1 provides further introduction; identifies some restrictions on the current project and the main issues that arise.
- Section 2 discusses what asset(s) are acquired by a purchaser under a transaction involving variable and contingent consideration.
- Section 3 discusses what liabilities are assumed by a purchaser under a transaction involving variable and contingent consideration.
- Section 4 discusses whether and how the assets and liabilities should be recognised.
- Section 5 discusses how a purchaser should report changes in the liability for variable and contingent consideration.

EFRAG TEG participants are specifically invited to discuss the questions set out at the end of sections 2–5.

Section 1 Introduction

Where this all starts

1.1 Much of financial reporting reflects exchanges of assets and liabilities. Typically, the purchaser gives an asset (usually cash) or assumes a liability to pay the seller a fixed amount in exchange for acquiring another asset. In such a case, it is clear what asset has been acquired, and what asset has been transferred or liability assumed.

1.2 However, sometimes things are not as straightforward. This paper addresses one kind of complication, which arises when the consideration promised by the purchaser is not fixed at the time of the transaction but depends on future events or decisions.

1.3 Often a transaction involving variable or contingent consideration also requires the purchaser to pay a fixed amount. But this is not a necessary condition—all the consideration may be variable or contingent.

1.4 Several IFRSs specify the accounting for transactions that involve variable and contingent consideration. The underlying principles of those requirements are not explicit, and so it is unclear whether they are consistent. Existing standards therefore do not provide an adequate guide as to what would be appropriate for future accounting standards.

1.5 This paper attempts to identify principles that will be helpful in the development of future accounting standards.

1.6 The IASB has, after considering responses to its 2015 Agenda Consultation, added the topic of variable and contingent consideration to its research pipeline. The IASB has also recently issued a revised Conceptual Framework,[1] which provides a natural starting point for the quest for consistent principles.

1.7 The boundary between 'conceptual' and 'standards-level' issues is fluid and arbitrary. Even if consensus is reached on a 'conceptually correct' solution, it does not follow that it would necessarily be followed in new standards or that existing standards that are inconsistent with that solution should be revised. For example, it might be judged that the cost of changing a standard to conform with the proposed principles would outweigh the benefits of the improvement in financial reporting. Or it might be that the conceptual principles use concepts

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[1] Conceptual Framework for Financial Reporting 2018. Hereafter 'Conceptual Framework' or simply 'the Framework'.

that cannot be specified in sufficiently precise terms that they unambiguously imply a particular solution to an accounting issue.

1.8 So, any conclusions reached in the course of the present project that are inconsistent with current IFRSs would not imply that revisions to IFRS are necessary. That would be considered by the IASB as part of its regular review of its agenda. While it should be useful for the principles to be considered in the development of future accounting standards, it may, of course, be concluded in some cases that a departure from them is desirable, for example because the cost of following the principles would not be commensurate with the benefit obtained from doing so.[2]

1.9 Later sections conclude that while the Framework is helpful in addressing some the issues relating to transactions involving variable and contingent consideration, there are some topics that seem to require further development. For these, an attempt has been made to identify the rationale that supports the requirements of some IFRSs.

What are the issues?

1.10 From the perspective of the purchaser, the Framework suggests that the questions that need to be answered are:

(i) What is/are the asset(s) acquired?

(ii) What is/are the liability or liabilities assumed?

(iii) Do the assets and liabilities meet the Framework's criteria for recognition? Is the recognition of income and expenses that result from such an approach representationally faithful?

1.11 These questions require consideration both:

(i) When the transaction is first recognised; and

(ii) When the amount of any recognised liability changes, does that change represent income or expense or a change in the asset or liability?

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[2] The Framework discusses the 'The cost restraint on financial reporting' at paragraphs 2.39–2.43 and makes several references to it in later chapters. However, the cost restraint is not addressed in this paper as in the view of its author, it is a practical rather than a conceptual, restraint on the ability of standard-setters to require the best financial reporting. This does not deny the importance of cost/benefit evaluations but only their relevance for the present discussion.

1.12 Identifying the issues does not imply that there is a single response to these issues that fits every transaction involving variable and contingent consideration: the objective of the project is to identify principles that will suggest when a particular answer is most appropriate, and when an alternative is more suitable.

1.13 There is quite a lot of interdependence between these issues, so thinking a way through them may require an iterative process. If, for example, it is concluded that the purchaser has acquired a particular asset, this suggests that it also has a liability to pay for it. But if further analysis suggests that the obligation to pay is not a liability, then the conclusion that the asset has been acquired becomes more questionable.

Scope restrictions

1.14 The scope of this paper is restricted in the respects highlighted below. These restrictions help avoid discussion of issues that seem to be more suitable for separate studies because they have a wider impact. In other words, the scope restrictions avoid mission creep.

Time value of money (discounting)

1.15 In a transaction involving variable and contingent consideration, payment is typically deferred until contingencies or other events have been resolved. Therefore, if a liability for such a payment is recognised at the time of the transaction, discounting would need to be considered. However, reflecting the time value of money in financial reporting arises in many other kinds of transactions. Therefore, this paper excludes issues such as which discount rate is appropriate and how unwinding of the discount should be presented. But changes in cash flow, which might arise when variable payments are linked to a benchmark interest rate, are included.

Transactions on market terms

1.16 Only transactions on market terms are considered in this paper. The term 'transactions on market terms' is that used in the Conceptual Framework: its use not intended to imply a significant difference from other expressions of the same idea such as 'arm's-length transactions' or 'exchanges of equal value'. It also does not imply that all assets and liabilities are traded on markets that would permit a 'Level 1' fair value measurement under IFRS i3 'Fair Value Measurement'. Indeed, a common motivation for transactions involving variable and contingent consideration is that the value of what is transferred cannot be objectively determined when the transaction takes place but will depend on the outcome of imponderable future events.

1.17 The restriction to transactions on market terms applies to the transaction as a whole. The parties to a contract might easily agree to a higher amount of fixed consideration in return for a lower amount of variable consideration or *vice versa.* It might therefore be unsafe to assume that any apportionment made in the contract between fixed and variable consideration faithfully represents the substance of the components of the transaction.

1.18 Some of the examples addressed in this paper are unusual. For example, it contemplates the purchase of a truck in exchange for a wager on the outcome of a horserace, which probably rarely occurs in a business context. But principles should be universally applicable, and so they must be tested against rare cases as well as the familiar. Inviting consideration of unfamiliar cases also guards against falling back into established approaches. Nonetheless, the examples addressed are all conceivable: they might be agreed between the parties to a contract on market terms.

Consideration is cash

1.19 Probably most transactions are denominated in cash, so that the restriction to transactions where the consideration (whether fixed or variable) is denominated in cash will not significantly reduce the validity of the discussion.

1.20 Transactions denominated in foreign currency, however, are fairly common and provide an interesting comparison with other cases. While the accounting for foreign currency is not controversial, it is necessary to address whether any principles developed in the course of the project are consistent with current requirements.

1.21 The restriction to cash transactions also avoids discussion of the following issues that are more appropriately addressed in separate projects.

(i) When a previously recognised asset or liability is derecognised as a result of a transaction on market terms, should any difference between its carrying amount and its fair value be recognised as income or expense?

(ii) Transactions that require settlement in the purchaser’s own equity.

Historical cost accounting

1.22 Historical cost accounting is likely to continue to be widely used for the foreseeable future. The current paper therefore concentrates on transactions that result in assets and liabilities measured at historical cost.

Section 2 What assets or (assets) are acquired?

Assets are rights, not physical objects

2.1 The Conceptual Framework clarifies that conceptually, assets are rights rather than, for example, physical objects, and each right is a separate asset (paragraph 4.11). Legal ownership of a physical object may give rise to several rights (such as rights to use the object, rights to sell it, rights to pledge it), but these are generally accounted for as a single asset and this *'will often provide a faithful representation of those rights in the most concise and understandable way'*. (paragraph 4.12)

2.2 However conceptually admirable, this perhaps does not reflect the thought process typical of the practical accountant. On learning that the entity has purchased a truck on credit, the accountant probably does not make an inventory of the rights arising from that purchase and then consider whether accounting for the various rights as a single asset provides a faithful and understandable representation of the transaction. Usually the truck and a creditor (or, if already paid, a reduction in cash) will be recorded as an asset and a liability without hesitation.

Truck purchased in foreign currency

2.3 But suppose the liability to pay for the truck is denominated in a foreign currency? From the perspective of the purchaser, the consideration is variable as the amount ultimately payable will vary as exchange rates change. However, the asset acquired is identical to that which would be acquired if the transaction were denominated in the entity's functional currency. The same would apply if the variation in the consideration was subject to other factors, such as changes in a benchmark interest rate or, perhaps more fancifully, the winner of the next Derby horse race.

2.4 In such a case it seems safe to conclude that the purchaser has acquired an asset equivalent to that which would be obtained if the contract required immediate payment in full. The asset should therefore be recorded at cost, which would normally be equivalent to the fair value of the consideration given and be expected to be approximately the same as that would be payable if the

transaction were negotiated so as to require immediate payment in the entity's functional currency.[3]

Publisher example

2.5 Suppose a publisher and an author enter into an agreement for rights to publish a novel. The author retains no rights to the novel, but only the right to receive the consideration required by the contract, which is an unconditional payment of CU5,000, and a further payment of CU1 for each copy of the novel that is sold after the first 5,000 copies. The publisher estimates that total sales of the novel will be 8,000 copies. The publisher is under no obligation to print or market the novel.

2.6 As the publisher has acquired exclusive rights to the novel, it might be suggested that the most representationally faithful portrayal of its asset would be to report those rights as a single asset, presumably at the amount that would be offered in a market transaction to purchase exclusive rights outright. This, however, is not the case, because the publisher is unable to sell more than 5,000 copies without making further payment. A more exact analysis is that the publisher has acquired two assets:

(i) The right to publish and sell 5,000 copies of the novel; and

(ii) An option to publish and sell further copies of the novel, on payment of CU1 for each copy.

Racehorse example

2.7 A transaction in which a commercial entity acquired a truck in exchange for a wager on a horse race was imagined above. It was suggested that in that case the entity would have an asset equivalent to ownership of the truck, and that the value of the wager would be expected to be about the same as the amount of cash that would be required for a cash purchase.

2.8 We might also imagine a contract for the sale of a racehorse—let's call it Pegasus—and that the contract requires a fixed payment plus additional

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[3] This sidesteps some important issues. IAS 21 'The Effects of Changes in Foreign Exchange Rates' requires that a foreign currency transaction is recorded on initial recognition at the spot rate. One possible alternative is that the forward rate should be used, but, if it is the case that differences between the spot and forward rates are due to interest rate differentials, a discussion of that issue would not belong in this paper, because of its exclusion of the time value of money (see paragraph 1.15). A third possibility would be to use the (spot or forward) rate prevailing at the time the order is placed. This would be consonant with the rationale for historical cost discussed at paragraphs 5.11–5.12 below.

consideration of 60% of the prize money if Pegasus wins the next Derby. To be equitable, such a contract would have to impose other terms on the purchaser, such as not changing training arrangements or withdrawing from the Derby.

2.9 Some would consider that the purchaser's rights over Pegasus are significantly less than those that would be held by an outright owner. An outright owner would not be restricted in its choice of training arrangements, nor of what races to enter Pegasus into. An outright owner would also be able to keep all of Pegasus' winnings. It follows that it would not be representationally faithful to report Pegasus in exactly the same manner as if the purchaser had acquired outright ownership. On this view, the purchaser's asset cannot be faithfully represented as 'a racehorse': rather it is 'an interest in a racehorse'.

The unit of account

2.10 Some may question the conclusions advanced above. They may find it counterintuitive to conclude that the publisher has not acquired all the rights to the novel, and that Pegasus' new owner has acquired only a partial interest in a racehorse rather than total ownership. Support for this view might be claimed from the discussion in the Framework of 'unit of account' which identifies, as a possible unit of account:

> *'all rights, all obligations, or all rights and all obligations, arising from a single source, for example, a contract'* (paragraph 4.55(b)).

On this view, the act of entering into the contract would be past event that gives rise to a present economic resource (that is, rights that have the potential to produce future economic benefits) equivalent to that of outright ownership. This analysis is, however, questionable.

2.11 The Framework's lists a number of possible units of accounts, of which that quoted above is simply one. It is immediately followed by:

> *a subgroup of those rights and/or obligations—for example, a subgroup of rights over an item of property, plant and equipment for which the useful life and pattern of consumption differ from those of the other rights over that item.* (paragraph 4.55(c)).

2.12 As the Framework does not attempt to identify the most appropriate unit of account in any specified circumstance, it provides no support for seizing on any particular solution.

2.13 A more substantive objection to the claim that the 'total ownership view' conforms to the Framework is provided by the Framework's discussion of the idea of 'control' which is part of the definition of an asset. In that discussion (at paragraphs 4.19–4.20) the Conceptual Framework observes:

> *Assessing whether control exists helps to identify the economic resource for which the entity accounts. For example, an entity may control a proportionate share in a property without controlling the rights arising from ownership of the entire 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.*

2.14 So it cannot be in conformity with the Framework to argue that the purchasers in our examples have acquired the entire subject matter of the contract (publishing title or racehorse). This is reinforced by the next paragraph of the Framework, which states:

> *An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it. Control includes the present ability to prevent other parties from directing the use of the economic resource* <u>*and from obtaining the economic benefits that may flow from it*</u>*. It follows that, if one party controls an economic resource, no other party controls that resource.* (Emphasis added.)

2.15 In our examples, the publisher cannot obtain all the economic benefits that an 'outright purchase' of all rights to the novel would bring: after the first 5,000 copies have been sold, the economic benefits that flow to the publisher are reduced by CU1 per copy. Equally, the purchaser of Pegasus cannot obtain all the prize money that Pegasus will win, as a share of some such winnings is due to the seller.

Substance of contractual rights

2.16 The above discussion needs to be qualified in one respect. It has been implicitly assumed that the difference between:

(i) the rights acquired by the purchaser under a transaction involving variable and contingent consideration; and

(ii) the rights that would be obtained by a purchaser in the case of an outright purchase;

are significant and substantive.

2.17 The Framework is clear that faithful representation requires that financial statements report the substance of rights and obligations (paragraphs 2.12, 4.59–4.61). To the extent restrictions on the purchaser lack substance, that is, they have no discernible effect on the economics of the transaction, they do not affect its analysis. In some cases restrictions on the purchaser may be dealt with by recognising the whole asset and disclosing the restrictions in a note to the financial statements: for example it may be representationally faithful to report a factory as an item of property, plant and equipment if the only restriction is that it is pledged as security for borrowings, provided that fact is disclosed.

Assets that are immediately consumed

2.18 The Framework also observes that:

> *Some goods or services—for example, employee services—are received and immediately consumed. An entity's right to obtain the economic benefits produced by such goods or services exists momentarily until the entity consumes the goods or services.* (paragraph 4.8).

2.19 In such cases the goods or services received and consumed will be reported as an expense. Where the consideration is variable and contingent, the discussion in subsequent sections of this paper is relevant.

Concluding comments on assets

2.20 Determining the assets that are acquired by the purchaser in a transaction involving variable and contingent consideration often requires careful analysis of the rights that arise from the transaction. It is often helpful to compare these rights with those that would arise from an outright cash purchase. In some cases, as in the foreign currency example, there will be little significant difference and a representationally faithful portrayal of the asset can be achieved by reporting the subject of the contract as an asset. In other cases, the purchaser's interest may be less than would be acquired in an outright purchase. It is then necessary to consider whether the assets acquired by the purchaser include options, as in the publisher example.

2.21 Of course, reporting these assets in the primary financial statements is subject to a consideration of the criteria for recognition, which are discussed in Section 4 below.

Question for EFRAG TEG participants	
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?

Section 3 What liabilities are assumed?

3.1 In a transaction involving variable and contingent consideration, the purchaser will always have a liability for any fixed consideration (to the extent it is unpaid), so the question of whether it has an additional liability arises only in respect of the variable amount.

3.2 The Conceptual Framework defines a liability as follows:

A liability is a present obligation of the entity to transfer an economic resource as a result of past events (paragraph 4.26).

3.3 The following summarises the principles in the Conceptual Framework for the existence of a liability:

(i) the entity must have an obligation: that is, a duty or responsibility that the entity has no practical ability to avoid (paragraphs 4.28—4.34).

(ii) The obligation must be to transfer an economic resource (paragraphs 4.36—4.41).

(iii) The obligation must be a present obligation that exists as a result of past events (paragraphs 4.42–4.47). This requires that the entity has received economic benefits or taken an action, and as a consequence will or may have to transfer an economic resource that it would not otherwise have had to transfer.

3.4 The Framework is clear that all three criteria must be met for a liability to exist (paragraph 4.27). An entity may, for example, have no practical ability to avoid paying for next year's raw materials. However, because this obligation does not result from a past event (the materials are yet to be received) there is no present obligation, and hence no liability.

3.5 The Framework also notes that an executory contract (that, is a contract, or portion of a contract, that is equally unperformed) establishes a combined right

and obligation to exchange economic resources, which constitute a single asset or liability. The entity has an asset if the current terms of exchange are favourable and a liability if the current terms of exchange are unfavourable (paragraphs 4.56–4.58).

Foreign currency example

3.6 In some cases it is straightforward to conclude that a liability exists. As noted in paragraph 2.3 the variation in the consideration payable may be dependent only on factors—such as changes in foreign exchange rates—that are outside the control of the purchaser, and so do not give the purchaser the 'practical ability to avoid' the obligation to pay. It was concluded that in such a case the purchaser has received an asset (a truck) that was equivalent to that which would be obtained by an outright purchase for cash in the entity's functional currency. Therefore the 'past event' criterion is also met. As the obligation is clearly one to transfer an economic resource, all the requirements for the existence of a liability are met.[4]

3.7 It was also suggested above that the asset (a truck) acquired would be no different if the variation in the consideration payable was subject to an uncertain future event, such as the winner of the next Derby horse race. For the same reasons as in the foreign currency example the 'no practical ability to avoid' and 'past event' criteria are met. If there is any doubt as to whether the 'obligation to transfer economic resources' criterion is met—which would seem plausible only if the odds were long—the Framework is explicit on the point:

> *it does not need to be certain, or even likely, that the entity will be required to transfer an economic resource—the transfer may, for example, be required only if a specified uncertain future event occurs. It is only necessary that the obligation already exists and that, in at least one circumstance, it would require the entity to transfer an economic resource.* (paragraph 4.37)

3.8 Hence the obligation to pay consideration in this case also satisfies all three of the criteria, and the purchaser has a liability.

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[4] This rationale is essentially the same as that given in relation to 'Variable lease payments that depend on an index or rate' in the Basis for Conclusions to IFRS 16 'Leases': *the IASB decided to include variable lease payments that depend on an index or a rate in the measurement of lease liabilities. Those payments meet the definition of liabilities for the lessee because they are unavoidable and do not depend on any future activity of the lessee. Any uncertainty, therefore, relates to the measurement of the liability that arises from those payments and not to the existence of that liability.* (paragraph BC165).

Publisher example

3.9 In the publisher example, does the publisher have a liability at the inception of the contract? It will be recalled that, while the publisher is under no obligation to print or market the novel, it is obliged to pay additional consideration of CU1 for each copy sold above 5,000.

3.10 The publisher's position at the inception of the contract as regards the variable consideration and the Framework's criteria for the existence of a liability may be summarised as follows:

No practical ability to avoid?	No—publisher is under no obligation to sell any copies.
Obligation to transfer an economic resource?	Yes
Arises from past events?	No
Conclusion	**No liability**

3.11 Some may be troubled by the conclusion that no liability exists for the variable consideration at the inception of the contract. Their discomfort may be particularly acute if the publisher is confident that the sales from the novel will almost certainly exceed the 5,000 copy threshold and that, taking account of the additional consideration payable, these sales will be profitable. It might be urged that failing to report a liability for the additional consideration that is highly likely to involve a cash outflow does not help the users of financial statements who are, as the Framework notes, interested in assessing the amount, timing and uncertainty of future net cash inflows to the entity (paragraph 1.3).

3.12 The Framework, however, does not support the view that the most useful information that financial statements can provide is a condensed statement of forecast cash flows. Instead it emphasises the usefulness of information about economic resources, claims against the entity and changes in those resources and claims.

3.13 This is emphasised in the case of liabilities, where the Framework states that:

in some cases, an entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have economic consequences significantly more adverse than the transfer

itself. However, 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. (paragraph 4.34, emphasis added).

3.14 It follows that irrespective of the publisher's intentions, or the prospects of profitable future sales, the publisher does not have a liability in respect of the consideration that would be required if it publishes more than 5,000 copies.

Racehorse example

3.15 Reverting to Pegasus illustrates a different point. Recall that the contract requires the purchaser to pay additional consideration of 60% of the prize money if Pegasus wins the next Derby. The contract also imposes other terms on the purchaser, such as not changing training arrangements or withdrawing from entry in the Derby.

3.16 Because of the contractual restrictions, the purchaser has no realistic alternative to avoid the obligation to pay[5], and the obligation is clearly one to transfer economic benefits. There remains only the 'past event' criterion: does the obligation arise as a result of past events? The Framework guidance on this point is:

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)

3.17 Because it includes a reference to the receipt of economic benefits[6], the past events criterion creates an inter-dependence between the definition of an asset

[5] Strictly, a contract does not create an enforceable obligation on either party to perform their obligations. More precisely, a party to a contract must either perform its obligations or recompense the other party for the loss caused by their failure to perform. However, in the present example the obligation to recompense would be at least as great as the obligation to perform.

[6] There appears to be an inconsistency in drafting between the 'past events' criterion for the existence of a liability and the Framework's definition of an asset. The discussion of assets leads one to conclude that goods, for example, are not "economic benefits" but ownership of goods would be "an economic resource" which has the potential to produce "economic benefits", and therefore qualifies as an asset. As the wording of the 'past events' criterion refers to "economic benefits" this would

and that of a liability. Whether Pegasus' purchaser has received economic benefits depends on the analysis of the asset received at the inception of the contract. If it were concluded that the purchaser acquired rights equivalent to that of outright ownership of Pegasus, then the 'past event' criterion would be fulfilled and the obligation to pay variable consideration would qualify as a liability. But it was concluded above that the purchaser's rights are less than that of outright ownership, and therefore the past events criterion is not met, so the variable consideration is not a liability.

Practical ability to avoid

3.18 In both the publisher and the racehorse example it is relatively easy to determine whether the 'no practical ability to avoid' criterion is met, but this is not always the case.

3.19 The Basis for Conclusions to the Framework laconically notes that:

> *Applying the criterion of 'no practical ability to avoid 'will require judgement.* (paragraph BC 4.54)

3.20 The Framework (paragraph 4.33) is explicit that, if financial statements are prepared on a going concern basis, an entity has no practical ability to avoid a transfer if the only means of doing so is by going into liquidation or ceasing to trade.

3.21 It is not clear how to reconcile this with the injunctions in IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' against recognising liabilities for future expenditure that will be necessary for the entity to remain in business (fitting smoke filters, relining furnaces and maintaining aircraft). However, IAS 37 does not use the language of 'no practical ability to avoid'.[7] The standard pre-dates the Framework by more than a decade and a half. The IASB is undertaking a research project to assess whether to amend certain aspects of IAS 37.

3.22 The Framework also notes that:

> *in some cases, an entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have*

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suggest that the past receipt of goods does not satisfy the past event criterion. However, by providing the example of obtaining goods as an example of obtaining economic benefits, it is clear that such a conclusion (which would lead to some surprising results) cannot be intended.

[7] Though the essential idea appears to be similar. IAS 37 comes close to the language of 'no practical ability to avoid' in its definition of 'obligating event' which refers to 'an entity having no realistic alternative'.

economic consequences significantly more adverse than the transfer itself. However, 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. (paragraph 4.34)

3.23 The Framework's Basis for Conclusions explains that the idea of 'adverse economic consequences' is intended to mean:

not just that it would be economically advantageous to make the transfer. Rather, the adverse economic consequences of not making the transfer are so severe that the entity has no practical ability to avoid the transfer. (paragraph BC4.55).

3.24 In some cases this is helpful. In the publishing example in paragraph 3.9 above, it is clear that the publisher has no obligation to publish any copies of the novel: it merely has the right to do so (with an additional payment in some circumstances). The clarification in the preceding paragraph makes it clear that this remains the case even if publishing the novel would be profitable. But, in other cases, the answer remains unclear. Questions that remain include the following.

(i) If a lease requires variable lease payments linked to the lessee's future use of the leased item, it would seem *prima facie* that the lessee has the practical ability to avoid such payments by refraining from use of the asset. But does this remain the case where the lessee has entered into a contract with a customer that can only be fulfilled by use of the leased property? For example, if a delivery company leases a truck on a lease that requires payments that increase with mileage, does the company have the practical ability to avoid increased payments if these will be triggered when it fulfils a fixed mileage contract with a customer?

(ii) Does a purchaser have the practical ability to avoid paying additional consideration that depends on the purchaser's future profits from the transferred item? Although in principle the purchaser could deliberately enter into loss-making transactions which would avoid the variable payments, such a course would have significant adverse economic consequences for the purchaser.

Question for EFRAG TEG participants	
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?

Section 4 Recognition of assets and liabilities

4.1 Once the assets and liabilities that arise from a transaction involving variable and contingent consideration have been identified, the next step is to consider whether their recognition is appropriate.

4.2 The Framework is clear that:

Only items that meet the definition of an asset, a liability or equity are recognised in the statement of financial position. Similarly, only items that meet the definition of income or expenses are recognised in the statement(s) of financial performance. However, not all items that meet the definition of one of those elements are recognised. (paragraph 5.6)

4.3 Thus the Framework:

(i) acknowledges that some items that meet the definition of assets and liabilities may not be recognised; and

(ii) forbids the recognition of items that do not meet the definition of elements of financial statements.

4.4 This provides a direction for some transactions involving variable and contingent consideration. Suppose a transaction requires a fixed payment of CU70 and variable and contingent consideration which is estimated to lead to payment of a further CU30. If analysis leads to the conclusion that the purchaser has acquired an asset that should be stated at a CU100, but that the obligation to pay variable and contingent consideration does not meet the definition of a liability, then it would not be consistent with the Framework to recognise a liability for it. If it is concluded that it would not be representationally faithful to report income of CU30 at the time of the transaction, it could be concluded that the best information is provided by reporting the acquisition of an asset of CU70, matched by a liability (or reduction in cash, when paid) of that amount. Then it

would be necessary to consider whether further information about the unrecognised items should be provided in the notes to the financial statements, as observed in the Framework (at paragraph 5.11).

4.5 The Framework does not provide precise principles for recognition of assets and liabilities. But it does identify factors that are important influences on recognition decisions. In the context of transactions involving variable and contingent consideration the most important of these seem to be:

(i) 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).

(ii) 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).

Faithful representation

4.6 We are only contemplating transactions on market terms. It would be expected that initial recognition of an exchange on market terms should not result in the reporting of income or expenses. The Conceptual Framework supports this intuition.

if an asset is acquired or a liability is incurred in an exchange transaction on market terms, its cost generally reflects the probability of an inflow or outflow of economic benefits. Thus, that cost may be relevant information, and is generally readily available. Furthermore, not recognising the asset or liability would result in the recognition of expenses or income at the time of the exchange, which might not be a faithful representation of the transaction. (paragraph 5.17(a).

[It is necessary to consider]…*the depiction of resulting income, expenses and changes in equity. For example, if an entity acquires an asset in exchange for consideration, not recognising the asset would result in recognising expenses and would reduce the entity's profit and equity. In some cases, for example, if the entity does not consume the asset immediately, that result could provide a misleading representation that the entity's financial position has deteriorated* (paragraph 5.25 (a)).

Measurement uncertainty

4.7 The Framework notes that the level of measurement uncertainty of an estimate of the amount of the asset or liability may be so high that it is questionable whether it would provide a sufficiently faithful representation of the asset or liability and of any resulting income, expenses or changes in equity (paragraph 5.20).

4.8 The Framework goes on to suggest that:

(i) The most useful information may be a measure that relies on an uncertain estimate supplemented by disclosure. The measure supplied may be the most relevant, or a different measure that that is slightly less relevant but subject to lower measurement uncertainty (paragraph 5.21).

(ii) If all available measures would not provide useful information, the asset or liability would not be recognised, although it may be necessary to include explanatory information about it (paragraphs 5.22, 5.23).

Publisher example

4.9 Our publisher has agreed to pay additional consideration in the event that it sells more than 5,000 copies of the novel. It has been concluded above that as a result of this transaction it has acquired and assumed the following assets and liabilities:

(i) The right to publish and sell 5,000 copies of the novel;

(ii) An option to publish and sell further copies of the novel, at the price of CU1 per copy;

(iii) An obligation to pay the fixed consideration of CU5,000; but

(iv) No obligation to pay any of the variable consideration that would become payable if more than 5,000 copies are sold.

4.10 As noted above (paragraph 4.6) the Framework observes that in an exchange transaction, the cost of an asset generally reflects the probability of an inflow of economic benefits and thus provides relevant information. The publisher has clearly incurred a cost of CU5,000 and therefore reporting this as the acquisition of an asset would provide relevant information. However, the unconditional right to publish and the option to publish further copies might have to be accounted for separately (as separate units of account), because their useful life and pattern of consumption differ (Framework, paragraph 4.55(c)). The

unconditional right to publish 5,000 copies clearly differs in these respects from that of the option to publish and sell further copies.

4.11 Thus the amount of the fixed consideration would have to be apportioned between these two assets. The publisher may have sufficient knowledge from its experience of similar transactions to enable the relative fair values of these assets.[8] Subsequent accounting for the unconditional right to publish seems straightforward: it would be natural to amortise that asset by 1/5000 for each copy. Accounting for the option to publish further copies is more difficult, but if it is possible to evidence its fair value at initial recognition it would seem plausible that the fair value could also be used at subsequent reporting dates. Given that the transaction is on market terms, it is to be expected that the aggregate of the fair values would be equal to the amount of the fixed consideration.

4.12 But it is also necessary to consider the position where, at initial recognition, the relative fair values of the assets acquired cannot be attributed to the two assets acquired within a tolerable level of measurement uncertainty. The Framework might be read as implying that in such a case neither asset should be recognised. This would imply that the obligation to pay the fixed consideration should be reported simply as an expense, as no recognised asset is acquired in exchange for it. But perhaps a better solution is for the publisher to recognise ‘publishing rights’ at the total amount of the fixed payment of CU5,000, without attempting to disaggregate them between the unconditional and optional rights. Additional disclosure may be necessary to ensure that this depiction of the assets acquired is representationally faithful. This would also render the accounting for the hybrid asset in subsequent periods problematic, because it would be impossible to determine the extent to which it should be decreased by consumption of the unconditional right to publish 5,000 copies and increased or decreased by changes in the value of the option to purchase further copies.

4.13 Thus if the value of the two assets cannot be objectively be determined, either:

(i) Neither asset should be recognised on grounds of measurement uncertainty; or

(ii) A pragmatic assumption must be used.

4.14 One pragmatic approach would be to deem that the fixed payment is deemed to relate entirely to the unconditional right to publish and sell 5,000 copies of the

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[8] The Framework notes that in some circumstances where a cost cannot be identified, a current value may be used as deemed cost (paragraph 6.6).

novel and that none of it relates to the acquisition of the option to publish and sell further copies. Clearly this cannot be defended as the 'conceptually correct' solution. However, where concepts cannot be operationalised, this could be supported as the best available approach, especially as it could be supplemented by disclosure requirements and impairment reviews at subsequent reporting dates.

Racehorse example

4.15 The reasoning used in the publisher example applies equally to the racehorse example. The purchaser should report the interest in the racehorse at the amount of the fixed consideration, with additional disclosure as appropriate.

Question for EFRAG TEG participants

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 discussed in paragraph 4.14 above, that is, treating the amount of the fixed consideration as relating only to the unconditional rights obtained?

Section 5 Changes in the liability

5.1 A recognised liability for variable and contingent consideration will only by coincidence be settled for the amount at which it is first recognised. The Framework suggests that changes in the historical cost of a liability prior to fulfilment are recognised only when the liability becomes onerous (paragraph 6.8(b). However, whether the liability is subsequently measured at fair value or historical cost, the difference between the amount at which the liability is first recognised and the amount payable on its fulfilment will be recognised in the financial statements. This section addresses how this difference should be reported.

5.2 Where a liability for variable and contingent consideration is increased, the possibilities for reporting that change are:

(a) The change is reported as income or expense.

(b) The change is reported as an adjustment to the carrying value of the asset purchased.

5.3 The Framework provides little guidance as to the reporting of the debit arising when a liability that is reported at historical cost is increased. Therefore, this section draws on selected examples from IFRSs.

Options to purchase more—variations linked to future use of the asset

5.4 A relatively easy class of cases are those in which the purchaser exercises an option to 'purchase more', which crystallises an obligation for additional payments that would was not previously be regarded as a liability. Examples include our publisher publishing and selling additional copies of the novel, or a lessee exercising an option to extend the lease term. In such cases the purchaser receives the right to economic benefits that are properly reported as additional assets, or an increase in the carrying amount of a previously reported asset (unless immediately consumed). This is consistent with the requirement of IFRS 16 to record increases in variable lease payments linked to the future use of the asset as increases to the right-of-use asset.

5.5 The economic cost of the exercise of an option to 'purchase more' would be equivalent to the exercise price plus the fair value of the option at the exercise date. Reporting only the exercise price as the cost would not therefore be representationally faithful of the economic cost incurred, if the option was previously unrecognised, or reported at historical cost. However, if it is accepted that it is impracticable to report the option at fair value, reporting only the cost of exercise might be the best available approach.

Report as change in the value of the asset or as an expense?

5.6 The following paragraphs discuss two possible views on the reporting other changes in a liability for variable or contingent consideration, other than 'options to purchase more'. The rationale for these views differ: however the practical importance of that difference may be limited.

Report all changes as adjustments to the asset

5.7 IFRS 16 'Leases' requires that revisions to variable lease payments are accounted for as an adjustment to the right-of-use asset. The Basis for Conclusions notes that the IASB also considered whether some such changes should be reported in profit or loss, which would reflect the view that some changes could be viewed as events of the current period (paragraph BC192), but rejected that approach as:

a change in the estimate of the future lease payments is a revision to the initial estimate of the cost of the right-of-use asset, which should be accounted for in the same manner as the initial estimated cost.

5.8 This rationale seems to reflect the view that historical cost aspires to report the actual cost of assets acquired to the extent that have not been consumed. On this view, if the cost of a purchase can only be estimated at the time of the transaction, subsequent events that enable that estimate to be updated are properly reflected in the carrying amount of the asset. This is consistent with IAS 10 'Events after the reporting period', which gives as an example of an adjusting event (in paragraph 9(c)):

the determination after the reporting period of the cost of assets purchased…before the end of the reporting period.

5.9 The requirements of IFRS 16 seem to produce changes in the carrying value of an asset that are unintuitive. Changes in an index or rate (which are initially measured using the index or rate as at the commencement of the lease–IFRS 16 paragraph 27(b)) are reported as an adjustment to the right-of-use asset (paragraph 39), irrespective of whether they have any relationship to the value of the asset. This also applies to changes in the liability for a residual value guarantee: so if the liability is increased, for example because there is a growing awareness that machines of the type leased are generally unsatisfactory, then the amount attributed to the right-of-use asset is increased.

5.10 The requirements of IFRS 16 are difficult to reconcile conceptually with the requirement of IAS 21 that where a lease is denominated in foreign currency, changes in the liability are reported as income or expenses (see IFRS 16, paragraphs BC196–BC199).

Report changes as adjustments to the asset only where the value of the asset is increased?

5.11 A different view is that reporting the acquisition of an asset at its historical cost is justifiable as the transaction creates a presumption that the cost is recoverable. This view is reflected in the Conceptual Framework, as set out in paragraph 4.6 above. But this rationale does not support treating an increase in the liability after the transaction date as providing support for a presumption that the recoverable amount of the asset is increased. Rather it would suggest that before treating any increase in the liability as an adjustment to the carrying amount of the asset, it would be necessary to consider whether the factor that caused the change in variable payments provides evidence of a change in the

value of the asset. If not, on this view, changes in the liability would be reported as an expense.

5.12 Suppose, for example, the transaction is for the purchase of a mine, and the variable consideration becomes payable in the event that the price of the commodity produced by the mine increases: since the price increase would presumably result in the increase of the value of the mine, it might be regarded as consistent with this view to treat a change in the liability as an adjustment to the cost of the mine. But if the transaction were on the same terms but the value of the asset purchased bore no credible relationship to changes in the commodity price, the change would be treated as an expense.

Conclusions

5.13 The above discussion suggests that it might be useful to have greater conceptual guidance than that offered by the Framework, especially on the underlying principles of historical cost measurement. However, the issue may not be very important in practice. It would be expected to be unusual for a transaction to require variations in payment except where they relate to the value of the transferred asset. Also, wherever the value of an asset is increased, impairment reviews should ensure that the resulting carrying value is recoverable, or that the carrying amount is reduced.

Question for EFRAG TEG participants

4 Do you believe that, conceptually, all changes in a liability for variable and contingent consideration (other than 'options to purchase more', as discussed in paragraphs 5.4–5.55 above) should be accounted for as changes in the reported amount of the related asset as discussed in paragraphs 5.7–5.10 above, or prefer the approach discussed in paragraphs 5.11–5.12 above?

Do you agree that further consensus on the concepts underlying historical cost would be useful?