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Implications of different definitions of variable and contingent consideration
Issues Paper

Objective

1 The objective of this paper is to for EFRAG TEG to consider:

(a) The implications of different approaches to defining variable and contingent consideration; and

(b) How the EFRAG research project could be linked with the FRC research project.

FRC research project

2 At the November EFRAG TEG meeting a working draft related to the FRC research project on variable and contingent consideration will be presented (agenda paper14-03). This presentation provides input into EFRAG TEG's consideration of the objective in paragraph 1(b).

Implications of different approaches to defining variable and contingent consideration

3 The following paragraphs should assist EFRAG TEG members in its consideration of the implications of different approaches to defining variable and contingent consideration.

4 EFRAG TEG has previously tried to identify the accounting issues related to variable and contingent consideration. The issues identified are summarised in paragraphs 15 - 16 below.

5 At its September 2019 meeting, EFRAG TEG discussed how variable and contingent consideration should be defined. Various approaches were suggested by EFRAG TEG. The EFRAG Secretariat has tried to summarise these in paragraph 13 below. The summary is prepared on the basis of the EFRAG Secretariat's understanding of how to define variable and contingent consideration. Some comments at the meeting were related to which types of variable and contingent consideration should be discussed in EFRAG's discussion paper (i.e. the scope of EFRAG's discussion paper). These comments are summarised in paragraphs 56 - 59 below.

6 The view was expressed at the September 2019 EFRAG TEG meeting that a broad definition of variable and contingent consideration followed by a narrow scope would result in the same project as a narrow definition of variable and contingent consideration. It would therefore not be necessary to distinguish between defining variable and contingent consideration and deciding on the scope of the project.

7 This paper, however, distinguishes between defining variable and contingent consideration and the scope of a project on variable and contingent consideration. It does so because the EFRAG Board has identified the aims of the project as being:

(a) To identify the accounting issues around variable and contingent consideration;

(b) To outline the information needs of users of financial statements in regard to variable and contingent consideration based on the objectives of general-purpose financial reporting in the IASB's *Conceptual Framework for Financial Reporting* and consultation with the EFRAG User Panel;

(c) To summarise and compare the requirements in IFRS Standards and assess the rationale (or lack thereof) for any differences;

(d) To develop a number of accounting alternatives and illustrate their relspective strengths and limitations; and

(e) To consider improvements in presentation and disclosure.

8 In order to identify the accounting issues around variable and contingent consideration, it is necessary to define what variable and contingent consideration is. EFRAG may want to reduce the scope of the issues to be identified. However, in order to clarify for constituents that this has been a deliberate choice, and not because EFRAG considered variable and contingent consideration narrowly, it would be helpful to explain the aspects of variable and contingent consideration that are considered in the discussion paper.

9 A definition of variable and contingent consideration would also be important in a summary and comparison of requirements in IFRS Standards. For example, EFRAG TEG could decide that it would not consider how to account for variability caused by currency exchange rate fluctuations when developing accounting alternatives. Such a decision could be made because EFRAG TEG assesses that the current requirements work well. However, if EFRAG TEG considers that variability in consideration can be caused by changes in currency exchange rates, it would be relevant to consider the requirements for accounting for currency exchange rates and assess whether this variability is accounted for similarly to other types of variability and, if not, the reasons for the differences and the quality of those reasons. Knowledge about how variability caused by changes in currency exchange rates is accounted for would then also be relevant when developing accounting alternatives for variability that is not caused by changes in currency exchange rates.

10 This paper is also based on the assumption that the definite of variable and contingent consideration will be the maximum scope of a discussion paper. Accordingly, the definition of variable and contingent consideration will impact the issues that could be considered in the discussion paper (unless EFRAG TEG explicitly chooses to consider additional issues in the discussion paper).

11 Accordingly, when paragraphs 17 - 53 of this paper present some of the implications of the identified definitions listed in paragraph 13, it also identifies which issues would not be considered – because it would not relate to variable and contingent consideration in accordance with that particular definition.

No identification of a buyer and a seller

12 As in previous discussions about variable and contingent consideration, this paper does not attempt to identify a buyer and a seller. Instead, a transaction is regarded as an event where both parties are providing a contribution. The delivery of a service is considered to be a contribution.

Definitions considered or suggested by EFRAG TEG

13 EFRAG TEG has previously discussed the following definitions of variable and contingent consideration:

(a) A consideration is variable or contingent unless it is settled at the date of the transaction.

(b) A consideration to be transferred in exchange for an asset is variable or contingent unless:

(i) the entity is transferring a fixed amount in its functional currency; or

(ii) the terms of the exchange have not been agreed to a significant extent in advance of the exchange and the consideration is transferred at a single point in time, rather than over time or at multiple points in time.

(c) A consideration to be transferred in exchange for an asset is variable or contingent unless the entity is transferring a fixed amount in any currency.

(d) A consideration to be transferred in exchange for an asset is variable or contingent unless the entity is transferring a fixed amount in any currency or any changes in the amount is due to interest reflecting the time value of money.

(e) A consideration is variable or contingent unless the amount or number of items (i.e. any currency, good or service) and the qualities of these to be transferred in return for a fixed number or amount of other items of a set quality is fixed.

(f) A consideration is variable or contingent when the price (stated in a currency or in any other type of asset) can vary as a result of changes in factors that would normally be considered when determining the price of the asset received in exchange for the consideration. Under this approach, the first step is to account for / measure separately elements that have the characteristics of one or several of the following features:

(i) embedded derivatives;

(ii) components representing risks for which the variability in value is outside the contract boundaries;

(iii) components in which it is possible to speculate in value changes; and

(iv) components that are not natural components of such a contract.

These components would be accounted for in accordance with the relevant Standard (e.g. as derivatives under IFRS 9 *Financial Instruments,* as provisions or contingent liabilities under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or separate performance components in accordance with IFRS 15 *Revenue from Contracts with Customers*).

After the above elements are accounted for separately, the approach mentioned above under (e) is applied to determine whether the remainder of the consideration is variable or contingent.

14 The EFRAG Secretariat considers that the classification of consideration as variable or fixed can be done when the terms of the consideration have been agreed, even if there are no immediate accounting consequences of the classification. Accordingly, even though a contract is executory, and no liability has been recognised for the consideration, the consideration to be transferred can be characterised as fixed or variable. Similarly, as long as the terms do not change, the categorisation of the consideration is not subsequently changed.

Issues related to variable and contingent consideration

15 In previous EFRAG TEG discussions, the following high-level issues related to variable and contingent consideration have been identified:

(a) *The definition issue:* If/when the variable or contingent consideration is considered as a separate unit of account for recognition purposes[1], whether/when it would meet the (new) definition of a liability.

(b) *The inconsistent measurement issue*: Requirements in Standards relating to recognition, initial measurement and subsequent measurement of a liability to transfer a variable contribution are different. This means that:

(i) To the extent the related asset is measured independently of the liability, a difference between the measurement of the liability and the asset would have to be reported in profit or loss (or OCI).

(ii) To the extent the related asset is measured based on the measurement of the liability, similar assets could be measured differently depending on which standard the consideration/the liability would be covered by.

In the following this issue is referred to as 'the inconsistent measurement issue'.

(c) *The cost issue:* How/whether variable and contingent consideration should be included in 'cost'. In the following this issue is referred to as 'the cost issue'.

(d) *The asset measurement update issue*: How/whether subsequent changes in the amount of variable and contingent consideration should be reflected in the measurement of the acquired assets. Currently some Standards (and Interpretations) provide guidance on this issue. However, the guidance is inconsistent and may not be intended to be applied by analogy for other areas. In the following this issue is referred to as 'the asset measurement update issue'.

(e) *The value change issue*: Whether/how to account for value changes of the consideration to be transferred, when there is a time lag between the agreement of what to transfer and the transfer. In the following this is referred to as 'the value change issue'.

16 It has also been noted that the existence of variable and contingent consideration may reflect that the transaction includes a financing component or a risk-sharing arrangement. However, as this issue is not directly linked to how to account for variable and contingent consideration, it has not been included in the list in paragraph 15 above.

Implications of the various definitions considered by EFRAG TEG

17 This section explains some of the implications of the definitions of variable and contingent consideration listed in paragraph 13 above. That is, this section provides examples of the types of consideration that will be classified as fixed consideration and the types of consideration that will be regarded as variable or contingent consideration according to the definition being applied.

18 As noted in paragraph 11 above, this section also discusses how the various definitions will impact on the issues listed in paragraph 15. The discussion is summarised in a table for each of the approaches. The table shows whether the types of possible variabilities that could be considered in relation to each issue would be

(a) the same (0) or

(b) lower (- (moderately lower), --, --- or ---- (significantly lower))

than under the first approach listed in paragraph 13 – i.e. the approach listed in paragraph 13(a). Although a minus sign '-'has been used, this does not indicate that

[1] The unit of account could be different for, for example, recognition and measurement.

it is necessarily an undesired effect that fewer types of possible variabilities will be considered under a given definition.

19 The definitions are referred to by the order in which they appear in paragraph 13. That is, the definition appearing in paragraph 13(a) is referred to as 'Approach (a)', and so on.

Approach (a) – the base case

20 Under Approach (a) consideration is considered variable or contingent unless it is settled at the date of the transaction. This means that a transfer of EUR 100 (which is assumed to be the functional currency of an entity) in 100 days will be classified as variable or contingent consideration under Approach (a). The definition would consider a consideration to be variable or contingent if the present value of what is to be transferred at a later point in time differs from the amount to be transferred, although the amount to be transferred would not be subject to changes.

21 There may be very limited cases under which the payment of interest would be considered fixed consideration under Approach (a). Such cases would be limited to situations under which interest is paid (and not just accrued) continuously over the period of a loan.

22 The definition would make it possible to address all the issues identified in paragraph 15 as it appears in the table to the right.

The definition issue	0
The inconsistent measurement issue	0
The cost issue	0
The asset measurement update issue	0
The value change issue	0

Approach (b)

23 Approach (b) states that a consideration to be transferred in exchange for an asset is variable or contingent unless:

(a) The entity is transferring a fixed amount in its functional currency; or

(b) The terms of the exchange have not been agreed to a significant extent in advance of the exchange and the consideration is transferred at a single point in time, rather than over time or at multiple points in time.

24 In contrast to Approach (a) this approach would mean that a transfer of a fixed amount in the functional currency of the entity is considered to be fixed even if there is a time lag between the time when the amount is set and when it is transferred.

25 Under Approach (b) interest payments in the functional currency of the entity would only be considered to be variable consideration in cases where the interest rate is not fixed for the time period the entity will have to pay the interest. Approach (b) would mean that:

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

(b) If a loan is provided for an indefinite period of time the consideration would be considered fixed for the entity (which is borrowing the money) if the interest for the following period is set at a point in time at which the reporting entity can repay the loan. Under that scenario, it would be considered that borrowing the money for the following period would be a new service the entity will receive in exchange for the fixed amount it will pay (the fixed interest) for this service. On the other hand, if the entity can repay the loan at the beginning of the month but the interest for the month is only determined at the end of the month, the consideration would, under Approach (b), be considered variable.

26 Similar to Approach (a), consideration under Approach (b) would be variable or contingent under the following scenarios:

(a) An entity has acquired an asset. The asset will be paid for in 30 days at an amount in its functional currency that will correspond to the asset's fair value as of the payment date.

(b) An entity has received a vehicle. In exchange it has to provide a weekly cleaning service over the coming year. The agreement specifies what should be cleaned, however, the entity can decide on how it will perform the cleaning and which people it will use (e.g. whether it will use experienced and faster, but also more expensive personnel or less experienced, slower but also less expensive personnel). Compared with the price the entity would have had to pay in cash for the vehicle, the entity expects that the costs of providing the cleaning service will be less. However, the profit margin on providing the cleaning service will be less than if had delivered the cleaning service for an amount in cash under normal circumstances. It follows that the transfer of the entity is not in the functional currency of the entity nor is the transfer of the cleaning service taking place at a point in time.

(c) An entity agrees to transfer a vacuum cleaner in one year in exchange for a refrigerator it has just received.

(d) An entity with EUR as functional currency agrees to transfer an amount in Argentine Pesos corresponding to EUR 1 000 in 6 months as a payment for a bicycle produced in Argentina it has received.

27 The definition would make it possible to address all the issues identified in paragraph 15 as it appears in the table to the right. However, under this approach it is not considered that the fact that a transfer in the entity's functional currency in the future would not have the same value as a transfer today, would result in the consideration being categorised as variable or contingent. Accordingly, changes in the (time) value of an obligation to transfer a fixed amount in the entity's functional currency would not be an issue that would logically fall into the scope of the discussion paper under this definition.

The definition issue	0
The inconsistent measurement issue	0
The cost issue	0
The asset measurement update issue	0
The value change issue	-

Approach (c)

28 Under Approach (c) consideration to be transferred in exchange for an asset is variable or contingent unless the entity is transferring a fixed amount in any currency.

29 Unlike Approach (a) and Approach (b), Approach (c) would result in a future transfer of a fixed amount in yen by an entity with EUR as functional currency being considered as a fixed consideration.

30 The four scenarios listed in paragraph 26 above would be considered similarly to Approach (a) and Approach (b).

31 While under Approach (c) a transfer of a fixed amount in yen by an entity with EUR as functional currency would be considered as a fixed consideration, a transfer in EUR which would equal the value of a fixed amount in yen would be variable or contingent although the two transactions would be economically similar.

32 Approach (c) would require a definition of what a currency is. For example, it would have to be decided whether Bitcoins is a currency or not. It would also be necessary to consider what the qualities of a currency are that could support that a fixed amount in any currency should be accounted for differently (as fixed consideration) than, for example, the transfer of a fixed amount of gold, oil or government bonds.

33 Approach (c) would make it possible to address all the same issues as Approach (b) except that, under Approach (c):

(a) the cost issue cannot include how the cost price of an acquired asset that has been (pre-)paid by transferring an amount in a foreign currency is determined.

The definition issue	0
The inconsistent measurement issue	0
The cost issue	-
The asset measurement update issue	-
The value change issue	--

(b) the asset measurement update issue would not consider whether/how changes in foreign currency exchange rates should subsequently be reflected in the measurement of an acquired asset.

(c) changes in the value of an obligation to transfer a fixed amount in any currency would not be an issue to consider under 'the value change issue' as it would not relate to variable or contingent consideration.

(d) changes in the value of the currency to be transferred due to changes in the exchange rate would not be an issue that would relate to variable or contingent consideration.

Approach (d)

34 Under Approach (d) consideration to be transferred in exchange for an asset is variable or contingent unless the entity is transferring a fixed amount in any currency or any changes in the amount is due to interest reflecting the market rate of the time value of money.

35 Unlike Approach (a), Approach (b) and Approach (c), Approach (d) would classify an amount in a currency as fixed if it will (only) be adjusted by a variable market interest rate that the entity cannot avoid paying.

36 The four scenarios listed in paragraph 26 above would be considered similarly to Approach (b).

37 Approach (d) would make it possible to address the same issues as Approach (c) except that under Approach (d):

(a) the definition issue would not cover whether an agreement that the entity in the future would have to pay a variable interest rate, would represent a current liability.

The definition issue	-
The inconsistent measurement issue	0
The cost issue	-
The asset measurement update issue	--
The value change issue	---

(b) the cost issue would not include whether/how the cost price of an asset should reflect interest paid / the time value of money.

(c) the asset measurement update issue would not consider whether/how changes in interest rates should subsequently be reflected in the measurement of an acquired asset.

(d) the cost issue cannot include how the cost price of an acquired asset that has been paid in advance or in arrears should be determined.

(e) changes in the value of the asset to be transferred due to the time value of money would not be an issue that would relate to variable or contingent consideration.

Approach (e)

38 Under Approach (e) consideration is variable or contingent unless the payment in (in an amount or number of any currency or other items of a specified quality), to be transferred in return for a fixed number or amount of other items of a set quality, is fixed.

39 Unlike Approach (d) this approach would classify consideration as variable or contingent if it would be adjusted by a variable interest rate.

40 Under Approach (e) a future transfer of a fixed amount in any currency would be considered fixed consideration. However, a future payment of an amount in one currency that would equal a fixed amount in another currency would be considered variable. The same would apply for assets other than cash. For example, if a future consideration is specified in a contract to be one kilo of gold, this consideration would be fixed. However, if it is specified that the future consideration should be the amount in EUR that would equal the price of one kilo of gold, the consideration would be variable.

41 Considering the examples provided in paragraph 26 above, the consideration in the following examples would be categorised as variable under Approach (e):

(a) An entity has acquired an asset. The asset will be paid in 30 days at an amount in its functional currency that will correspond to the assets fair value as of the payment date.

(b) An entity with EUR as functional currency agrees to transfer an amount in Argentine Pesos corresponding to EUR 1 000 in 6 months as a payment for a bicycle produced in Argentina it has received.

42 The consideration in the following two examples would accordingly be fixed:

(a) An entity has received a vehicle. In exchange it has to provide a weekly cleaning service over the coming year. The agreement specifies what should be cleaned, however, the entity can decide on how it will perform the cleaning and which people it will use (e.g. whether it will use experienced and faster, but also more expensive personnel or less experienced, slower but also less expensive personnel). Compared with the price the entity would have had to pay in cash for the vehicle, the entity expects that the costs of providing the cleaning service will be less. However, the profit margin on providing the cleaning service will be less than if had delivered the cleaning service for an amount in cash under normal circumstances. It follows that the transfer of the entity is not in the functional currency of the entity nor is the transfer of the cleaning service taking place at a point in time.

(b) An entity agrees to transfer a vacuum cleaner in one year in exchange for a refrigerator it has just received.

43 Under Approach (e), the cost issue cannot include how the cost price of an acquired asset that has been (pre-) paid by transferring an asset that is not the functional currency of the entity should be determined.

The definition issue	0
The inconsistent measurement issue	0
The cost issue	--
The asset measurement update issue	----
The value change issue	----

44 Under Approach (e):

(a) the asset measurement update issue would not consider whether/how changes in the value of the assets to be transferred measured in the functional currency of the entity (including changes in foreign currency exchange rates) should subsequently be reflected in the measurement of an acquired asset.

(b) changes in the value of an obligation to transfer a fixed quantity of an asset would not be an issue that would relate to variable or contingent consideration.

(c) any change in the value of the asset to be transferred would not be an issue that would relate to variable or contingent consideration.

Approach (f)

45 Under Approach (f) a consideration is variable or contingent when the price (in the currency or other type of asset that is specified in the contract) can vary as a result

of changes in factors that would normally be considered when determining the price of the asset received in exchange for the consideration.

46 For all the approaches considered above, before considering whether consideration is variable or not in a given contract, embedded derivatives should first be bifurcated in accordance with IFRS Standards. The same applies for a derivative contract attached to a host contract that is transferable separately from the host contract, or that is added by a third party. The consideration under these (bifurcated embedded) derivatives should then be assessed against criteria under the various approaches and be categorised as variable or fixed separately.

47 Under Approach (f), however, not only elements of a contract that meet the definition of a derivative in IFRS 9 should be separately identified. When considering if the consideration is variable of fixed, the existence of contractual terms that are separate to the basic transfer of good or services needs to be identified, and if identified, considered separately. A separation would, for example, take place in a case where it is agreed that an entity should transfer refrigerators to another entity in exchange for another asset, and the number of refrigerators to be transferred would depend on the USD/EUR exchange rate. As the USD/EUR exchange rate would normally not be considered when setting the price of the asset received, under Approach (f) the consideration would be considered to be fixed and would equal the number of refrigerators that would be transferred based on the USD/EUR exchange rate as of the date of the agreement. The right or obligation to deliver fewer or more refrigerators would then be accounted for in accordance with other relevant Standards (e.g. IAS 38 *Intangible Assets* or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or IFRS 9).

48 Under Approach (f), components representing risks for which the variability in value is outside of the contract boundaries or components in which it is possible to speculate in value changes should also not be considered when determining whether the consideration is fixed or variable.

49 An entity with EUR as the functional currency could have to pay a fixed amount in USD in 3 months. Under Approach (f) this would be considered to be a fixed contribution. The payment would be considered to be two separate transactions. The payment of a fixed consideration in USD and a position on the currency exchange risk.

50 If an entity would have to pay an amount in EUR in three months that would equal USD 100 (the counterparty's functional currency), the consideration would be considered to be variable according to the previous approaches. However, as the entity could easily hedge this position by acquiring USD 100 when entering into the agreement, the consideration would be considered fixed under Approach (f). The same would be the case if the entity would have to transfer e.g. either EUR 100 or Bitcoins worth EUR 100 in three months. Under Approach (f) it would be considered that the contract would have an embedded derivative that should be separated and accounted for using IFRS 9.

51 An example of variable consideration under Approach (f) would be if a building is purchased and an additional amount to be paid after one year depends on the general price changes of properties in a particular area. This amount would be variable under Approach (f) as the price changes of properties in a particular area would have to be taken into account when assessing the fair value of the building.

The definition issue	0
The inconsistent measurement issue	0

The cost issue	--
The asset measurement update issue	----
The value change issue	----

52 If Approach (f) would be applied to distinguish variable and fixed consideration, additional guidance may be necessary on when factors would normally be considered when determining the price of an asset and when it is easy to hedge a position.

53 Approach (f) would often dissect an agreement/contract into more variability elements than Approach (e). The assessment of which issues could be covered by the project would, however, be similar to Approach (e).

Summary of the different approaches

54 The table below summarises whether a particular consideration would be fixed (F) or variable (V) under the various approaches. A '?' marks that the classification would depend on additional factors (see paragraph 25(b) above).

Consideration \ Approach	**(a)**	**(b)**	**(c)**	**(d)**	**(e)**	**(f)**
The transfer of any type of goods (excluding cash) not agreed in advance of the transfer and the transfer takes place at a point in time	F	F	V	V	F	F
Fixed amount in entity's functional currency transferred in arrears	V	F	F	F	F	F
Amount paid in arrears in a foreign currency corresponding to a fixed amount in the entity's functional currency	V	V	V	V	V	F*
Fixed amount in any currency that is not the functional currency of the entity, transferred in arrears	V	V	F	F	F	F
Cash amount paid in arrears that (only) changes as a result of interest reflecting the time value of money	V	?	V	F	V	V
Fixed amount or number of goods or services (other than cash) transferred in arrears	V	V	V	V	F	F

*The consideration to be paid according to the derivative may be considered variable.

55 The table below summarises how the issues identified in relation to variable and contingent consideration would be affected by the definitions.

Issue \ Approach	**(a)**	**(b)**	**(c)**	**(d)**	**(e)**	**(f)**
The definition issue	0	0	0	-	0	0
The inconsistent measurement issue	0	0	0	0	0	0
The cost issue	0	0	-	-	--	--
The asset measurement update issue	0	0	-	--	----	----
The value change issue	0	-	--	---	----	----

Scope of EFRAG's discussion paper

56 Some EFRAG TEG members have expressed the view that variability covered by IFRS Standards should not be included in the scope of EFRAG's project because existing Standards work well. EFRAG TEG members have mentioned specifically that variability resulting from consideration being payable in a currency that is not the functional currency of the entity and payment of interest are already considered in IAS 21 *The Effects of Changes in Foreign Exchange Rates* and IFRS 9*.*

57 On the other hand, EFRAG TEG members have also noted that one of the issues that should be considered would be how changes in currency exchange rates should affect the cost price of an asset received in exchange for an amount in a foreign currency.

58 The view has also been expressed that the project should focus on variability that arises from factors intrinsic to the contract and the contracting parties.

59 As noted above in paragraphs 6 - 9, the EFRAG Secretariat would expect that the scope limitation would apply to the development of accounting alternatives (see paragraph 7(d) above) and not to comparison of requirements in IFRS Standards related to variable and contingent consideration (see paragraph 7(c) above).

Questions for EFRAG TEG

60 Could EFRAG TEG suggest other definitions of variable and contingent consideration than the definitions provided in paragraph 13 above?

61 Which definition(s) of variable and contingent consideration would EFRAG TEG choose (preliminary)?

62 Based on this paper and the presentation of the FRC project, are there any of the issues listed in paragraph 15, that should not be covered by EFRAG's project?

63 Does EFRAG TEG have other comments regarding the scope of EFRAG's project?