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Two examples of variable and contingent consideration Issues Paper

Objective

- 1 The objective of this session is to discuss two examples of variable and contingent consideration. The comments of EFRAG TEG on the two examples will provide the EFRAG Secretariat with an initial idea on EFRAG TEG's view on how to account for variable and contingent consideration.

Background of the project

- 2 In many transactions, the exchange price is not a fixed amount and could vary depending on financial and non-financial conditions. These conditions may include:
 - (a) Usage – a lessee pays a fixed amount for the lease of a copy machine, plus a variable fee for each copy made;
 - (b) Performance – an entity pays a fixed amount for the use of a license, plus a fee based on the amount of revenue generated by using the license;
 - (c) Rate or index – an entity pays a purchase price in instalments and the amount is adjusted for inflation or changes in foreign exchange rates;
 - (d) Future milestones – the price for a construction contract may be increased for a performance bonus or decreased for a penalty for late delivery; and
 - (e) Other events – a lessee pays a fixed fee for a portion of capacity of a broadcast tower. The lease payment is adjusted based on the total capacity used by the whole group of lessees – if an existing customer terminates its contract, the lessor can increase the rent to the remaining lessees.
- 3 Variable and contingent consideration is found in a broad range of transactions including:
 - (a) Purchases of tangible and intangible assets;
 - (b) Leases;
 - (c) Sales of goods or services;
 - (d) Share-based consideration;
 - (e) Pensions and other employee benefits; and
 - (f) Financial instruments.
- 4 Over some time, the IFRS Interpretation Committee debated a submission about initial recognition and subsequent measurement of variable consideration on the acquisition of tangible and intangible assets. Eventually, in March 2016, the

Committee concluded that the issue was too broad to address within the confines of the existing IFRS Standards and referred the issue to the IASB.

- 5 In its 2015 Agenda Consultation, the IASB suggested variable and contingent consideration as a possible project. Eventually it was considered to add it to the research pipeline. The IASB project may also look into risk-sharing features and participation agreements. The IASB will determine the exact scope and objective of this project when it becomes an active project.
- 6 Following the completion of the 2018 EFRAG research agenda consultation, the EFRAG Board approved to add a project on variable and contingent consideration to EFRAG's research agenda at its meeting in August 2018. The EFRAG Board discussed an initial project plan at its meetings in September and October 2018.
- 7 It is the intention that EFRAG's project should result in a Discussion Paper which could provide input to the IASB's project. It is planned to publish the EFRAG Discussion Paper in 2020.

Currently status of the project

- 8 The EFRAG Secretariat is currently performing interviews with experts from major audit firms in order to better understand the issues of the project. The interviews cover the following aspects:
 - (a) In which sectors and types of transaction variable and contingent consideration is (typically) found.
 - (b) How the variable and contingent consideration is typically determined in the types of transactions mentioned above (e.g. performance, usage, output of the asset and changes in market prices).
 - (c) How to define the scope of the project based on thoughts about the most urgent issues (based on diverging practices, frequency and magnitude).
 - (d) What kind of guidance that could be supported in respect of the variable and contingent consideration (e.g. measurement at fair value, likely amount to be paid or not including the variable part in the initial measurement).
 - (e) Whether there should be common guidance for all variable or contingent considerations or there should be different approaches.
 - (f) Particularly tricky real-life examples.
- 9 The EFRAG Secretariat has also examined the guidance related to variable and contingent consideration provided by the audit firms in their accounting manuals.
- 10 In December 2018, the EFRAG User Panel members discussed variable and contingent consideration. The objective of the session was to consider some practical cases and understand what information users need about the existence, uncertainty and variability of variable and contingent consideration. Members of the EFRAG User Panel generally agreed that a comprehensive and consistent approach to variable and contingent consideration would be preferable.
- 11 The EFRAG Secretariat will provide EFRAG TEG with the results of the current activities at a later meeting.

Question to EFRAG TEG

- 12 Does the EFRAG TEG have any comments or suggestions on the scope or on the description of the issues proposed for the research project on variable and contingent considerations?

Two examples

- 13 In this section two cases including variable or contingent consideration are considered.

Example 1

- 14 Entity A buys a machine for a fixed amount of CU 10 000 and a variable payment of CU 1 for each unit produced in the next 5 years. The best estimate of the future production is 40 000 units in total. After two years, the entity revises its best estimate of total production to 50 000 units (for simplicity, the time value of money is ignored):

Questions to EFRAG TEG

- 15 In order to provide the most useful information, at what amount should the machine be recognised at initial recognition?
- (a) At CU 10 000;
 - (b) At CU 50 000; or
 - (c) At fair value.
- 16 Should the entity be required to revise its estimate at each reporting date?
If so, how should the entity account for the remeasurement:
- (a) Should it adjust the carrying amount of the asset (the machine) and depreciate the adjustment prospectively over the residual useful life;
 - (b) Should it recognise the change in profit or loss; or
 - (c) Should it determine how much of the change is attributable to the variance in the current and prior periods and recognise to profit or loss/adjust the carrying amount of the asset accordingly?
- 17 What additional information (if any) should be required?
- 18 Does the entity's ability to decide how many units are produced affect the answers to the questions in paragraphs 15 - 17 above?
- 19 Should the entity's ability to predict reliably the final amount of consideration (potential variability) affect the answers to the questions in paragraphs 17 - 19 above?
- 20 Should the approach to account for variable and contingent consideration, as reflected in the answers provided to questions in paragraphs 15 - 17 above, be different for an entity that purchases a machine for a fixed amount of CU 10 000 and a variable payment of the higher of the annual increase in a consumer price index over the following 12 months and 2%?

Example 2

- 21 Entity B is a basketball club which signs a new player on a 5-year contract. In securing the registration of the new player, Entity B agrees to make the following payments to the player's former club:

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- (a) CU 7.5 million on completion of the transfer;
- (b) CU 2 million as soon as the player has made 20 appearances for the club (expected to happen);
- (c) CU 1.5 million when/if the player is selected to play for his national team (likelihood assess to be 25% - 40%);
- (d) CU 0.5 million if the team wins the season (tournament) (Entity B considers this to be likely, bookmakers assess the likelihood to be 30%);
- (e) CU 0.3 million if the player scores more than 10 points for each match of the season (expected to happen); and
- (f) 10% of the gross proceeds from any onward sale of the player before the expiry of the initial contract term (not expected).

Questions to EFRAG TEG

- 22 In order to provide the most useful information, at what amount should the player be measured at initial recognition?
- (a) At CU 7.5 million;
 - (b) At CU 7.8 million;
 - (c) At CU 9.8 million;
 - (d) At CU 10.44 million;
 - (e) At fair value; or
 - (f) At another amount?
- 23 Should the entity's ability control the outcome of the factors listed in paragraph 21 be taken into account when measuring the player at initial recognition?
- 24 Should the entity be required to revise its estimation at each reporting date? If so, how should the entity account for the remeasurement:
- (a) Should it should adjust the carrying amount of the asset and depreciate the adjustment prospectively over the residual useful life (period of contract);
 - (b) Should it recognise the change in profit or loss; or
 - (c) Should it determine how much of the change is attributable to the variance in the current and prior periods and recognise this to profit or loss; and adjust the carrying amount of the asset for the residual.
- 25 What additional information should be required?