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Identification of issues related to variable and contingent consideration
Issues Paper

Objective

1 The objective of this paper is to present accounting issues and accounting requirements related to variable and contingent consideration and ask for additional issues and requirements identified by EFRAG TEG. The paper will also ask whether EFRAG TEG considers that further activities should be performed by the EFRAG Secretariat to identify accounting issues related to variable and contingent consideration.

Accounting issues around variable and contingent consideration

Definition of 'variable and contingent consideration' for this paper

2 As mentioned in the cover note, a next step in the project, will be for EFRAG TEG to define what it considers 'variable and contingent consideration' to be. EFRAG TEG's decision may result in some changes to the inventory of relevant requirements collected by the EFRAG Secretariat.

3 For the purpose of this paper, however, it is considered that a party is providing a variable or contingent consideration in an exchange for one asset, unless the party is transferring:

(a) A fixed amount in the functional currency of the party; or

(b) An amount in the functional currency of the party which is only adjusted by an interest rate reflecting a financing component; or

(c) A fixed number of the entity's own equity instruments; or

(d) An asset or a group of assets that are specified and held by the party before it received the asset it is exchanging its assets for; or

(e) A combination of the above.

4 The assessment should be done for each asset the entity receives. This means that:

(a) The fact that an entity decides to purchase two items and accordingly must pay an amount twice as high as if it only bought one item, is not considered variable and contingent consideration.

(b) If an entity has acquired a right to use one copy machine for two years and the consideration it will have to pay depends on the number of copies it makes, the consideration for the *right-to-use* is variable. However, if an entity has access to a copy machine, for which no right-to-use should be recognised in its statement of financial position, a fixed price, it will have to pay for *each copy* it makes is not variable or contingent consideration.

Research approach

5 The EFRAG Secretariat is in the process of identifying issues around variable and contingent consideration and establishing the inventory of the various requirements that will have to be taken into account when considering various potential solutions that could be presented in a discussion paper – depending on the scope of the discussion paper. The purpose of this session is for EFRAG TEG to provide its input to the list of issues around variable and contingent consideration identified so far.

6 In addition to this session, to identify the accounting issues around variable and contingent consideration and establishing the inventory of relevant requirements, the EFRAG Secretariat plans to:

(a) Review the latest discussions and interpretations by the IFRS Interpretation Committee and the IASB on variable and contingent consideration (completed).

(b) Conduct interviews with experts from major audit firms (four interviews have been completed and the EFRAG Secretariat does not plan to conduct any additional interviews).

(c) Examine the guidance related to variable and contingent consideration provided by audit firms in their accounting manuals (ongoing).

(d) Compare the guidance across different IFRS Standards and examine whether current Standards are consistent and the reasons for any inconsistencies (if possible) (ongoing).

Outcome of the interviews with audit firms

7 The interviews with audit firms indicated that variable and contingent consideration is used in different situations, including:

(a) When the "right price" cannot be determined at the time of the transaction due to different sources of uncertainty (e.g. when the quantity/quality of an ore on a transferred mining site is unknown or when the item being sold does not have a significant additional cost (certain intangible assets)).

(b) When the seller and the buyer want to share some of the risks related to a transferred asset.

(c) When the buyer needs funding (and the seller accordingly provides deferred payment, against an interest, denominated in the seller's currency or retains part of economic ownership).

(d) When the seller needs funding, and the buyer acquires part of the asset in return for paying for ongoing investments in the asset.

(e) When the seller wants to stimulate further sales (for example by offering a discount on all items sold if the buyer purchases more than a given quantity over a fixed period of time).

8 Some of the industries most affected by variable and contingent consideration issues include mining, oil and gas, pharmaceutical, biotech, real estate, telecommunication, service concession, leasing, and financial services.

9 Use of variable and contingent consideration is most common for transactions involving intangibles, businesses (business combinations), mining sites, unique assets (including football players), property and assets exposing the owner to considerable risk; or in arrangements such as leases of tangible and intangible assets, service concession arrangements and franchise arrangements.

10 The variability can often be linked to: currency, interest, price development (e.g. price of land), indexes, entity-specific performance measures (e.g. EBITDA), future activity, usage of an asset, quality of an asset (for example of an ore), achievement

of milestones (for example a planning permission (for land) and regulatory approval (drug)) and volume purchased (volume discounts).

Summary of the accounting issues identified

11 The accounting issues identified so far are summarised below. The appendix 'Sources of information' describes:

(a) the issues discussed by the IFRS Interpretation Committee on variable and contingent consideration;

(b) guidance on variable and contingent consideration included in audit firms' accounting manuals; and

(c) main requirements in IFRS Standards on variable and contingent consideration.

12 The summary will first focus on the liability resulting from variable and contingent consideration. Although the issues discussed by the IFRS IC relate to the measurement of assets, it is relevant to consider the liability side as it may be considered that variable and contingent consideration should only be reflected in the measurement of an asset to the extent the definition of a liability would be met for the possible consideration (and the contingent consideration would be reflected in the liability).

13 The summary considers the situation from the perspective of the part in a transaction that will have to pay variable or contingent consideration. The payment can be in cash, in own equity instruments or be an obligation to transfer an asset (including performing a service) for which the outflow of resources is uncertain or variable. IFRS 15 *Revenue from Contracts with Customers* includes guidance for the receiver of variable and contingent consideration. This guidance is relevant to consider for the project and is included in the Appendix. However, the guidance is not reflected in the summary.

14 The summary shows that:

(a) The existence of variable and contingent consideration may reflect that the transaction includes a financing component or a risk-sharing arrangement.

(b) If/when the variable or contingent consideration is considered as a separate unit of account, there are diverging views on whether/when it would meet the definition of a liability.

(c) The requirements relating to recognition, initial measurement and subsequent measurement of the liability (or equity instrument) resulting from the variable or contingent consideration 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.

(d) Most standards requiring or allowing an asset to be measured at cost do not specify how/whether variable and contingent consideration should be included in 'cost' and how/whether subsequent changes in variable and contingent consideration should be reflected in the measurement of the asset. The standards (and official interpretations) that do provide guidance, provide inconsistent guidance and may not be intended to be applied by analogy.

Unit of account

15 One of the issues identified is whether, when purchasing an asset, a liability arises for any variable component that will depend on future actions or events. There does not seem to be diverging views as to whether any fixed part of a consideration would meet the definition of a liability in the *Conceptual Framework for Financial Reporting*. Accordingly, if the fixed component and the variable component(s) are considered as one unit of account, the definition of a liability would be met for the entire amount to be paid. How to account for the variable component(s) would therefore be a measurement issue. On the other hand, if the variable component(s) are considered to be a separate unit of account, divergent views exist as to whether these components would meet the definition of a liability. In addition, as the consideration could depend on multiple variable components and as whether or not the definition of a liability would be met could depend on the type of variability, it could also matter whether different variability components are considered as one or multiple units of account.

Definition of a liability

16 There does not seem to be diverging views on whether payments to be made in exchange for the transfer of an asset (that has been received) would meet the definition of a liability if these payments are unavoidable.

17 However, as indicated above, diverging views exist as to whether/under what circumstances an obligation to pay a variable amount that depends on future actions or events would meet the definition of a liability.

18 From the Basis for Conclusions accompanying IFRS 16 *Leases*, it thus appears (BC168 and BC169) that IASB members have different views on when the definition of a liability is met. Some IASB members do not think that a lessee's liability to make a variable lease payment linked to future performance or use of an underlying asset would exist until the future event requiring the payment occurs. Other IASB members think that all variable lease payments meet the definition of a liability because it is the amount of the liability that is uncertain, rather than the existence of that liability. However, IASB members agree that a liability exists at the commencement date of a lease agreement for variable lease payments that are in-substance fixed lease payments and variable lease payments that depend on an index or rate.

19 In cases under which the obligation to pay any amount would be an element in an executory contract, the *Conceptual Framework for Financial Reporting* explains that a liability only exists to the extent that the terms of the exchange are unfavourable. This is because the *Conceptual Framework for Financial Reporting* considers that the right and obligation established in an executory contract are interdependent and cannot be separated. Hence, the combined right and obligation constitute a single asset or liability.

Recognition of a liability

20 Consideration does not need to be in cash. It can be in any type of assets (including services) and own equity instruments. Different requirements apply to different types of consideration. Even for cash considerations different requirements exist depending on how the obligation has arisen and the type of asset received (e.g. the requirements for services received from employees are different from services received from an auditor). In relation to variable and contingent consideration, the differences in the requirements relate to:

(a) Whether the liability arises under a contract or not. Some requirements only apply to liabilities arising under a contract (IFRS 9 *Financial Instruments*), whereas other requirements also cover constructive obligations.

(b) What the variability/contingency depends on. Requirements for some types of liabilities would only result in recognition of a liability for certain specified types of variability (IFRS 16). Requirements for other types of liabilities may not distinguish.

(c) Whether the definition of a liability is met. Some requirements would only recognise liabilities that would meet the definition of a liability in the Conceptual Framework (or a similar definition) (IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* IAS 19 (profit-sharing and bonus payments) IAS 32). Other requirements would not consider this aspect (or assume implicitly that the definition is met).

(d) Recognition thresholds for an outflow to happen in the future. Some requirements would only result in the recognition of a liability if the probability of an outflow is above a given level (IAS 37). Others would not include such a threshold.

(e) Reliability of estimate. Some liabilities would only be recognised if the amount of the obligation can be measured reliably (IAS 19 (profit-sharing and bonus payments) and IAS 37). Other requirements do not include such a provision (or assume that the obligation can be measured reliably).

21 In relation to the recognition requirements, it should be noted that when the variable or contingent component meets the definition of an embedded derivative, it would need to be recognised separately.

22 According to the *Conceptual Framework for Financial Reporting*, only items that meet the definition of a liability or equity is recognised in the statement of financial position. However, not all items that meet the definitions are recognised. The *Conceptual Framework for Financial Reporting* does not include detailed guidance on when an item meeting the definition of a liability should not be recognised. It notes that a liability should only be recognised if it results in relevant information and a faithful representation. If the probability of an outflow of economic benefits is low, the most relevant information may be information about the magnitude of the possible outflows, their possible timing and the factors affecting the probability of their occurrence. Such information is typically included in the notes. However, even if the probability of an inflow or outflow of economic benefits is low, recognition of a liability may provide relevant information. Whether that is the case may depend on, for example, whether the liability is incurred in an exchange transaction on market terms or not. If it is incurred in an exchange transaction, recognition may be more relevant than if it is not. Measurement uncertainty may affect whether recognition would result in a faithful representation. In limited circumstances this could mean that a liability is not recognised. When assessing whether recognition (or no recognition) would result in a faithful representation, it should also be taken into account whether related assets and liabilities are recognised. If they are not, recognition may create a recognition inconsistency (accounting mismatch).

23 The interviews with audit firms revealed that in practice there is divergence in practice on whether/when to recognise a liability for variable and contingent consideration. Some of the factors considered by auditors when deciding on the preferred accounting treatment are:

(a) Whether the contract is executory.

(b) Whether the variable consideration is within the scope of IFRS 9 or IAS 37 (the latter includes a recognition threshold).

(c) Whether the variable consideration is linked to something the entity can avoid (e.g. sale of a specific product) or something it would be difficult to avoid (total sales). Economic compulsion is sometimes considered.

Initial measurement of a liability or equity instrument

24 The measurement of the liability or equity instrument related to having to make a variable or contingent consideration varies across Standards. The various measurement bases and methods include:

(a) measurement at the fair value of the assets received (IFRS 2 (equity-settled share-based payment);

(b) measurement at the fair value of the liability (IFRS 2 (cash-settled share-based payment), IFRS 3 and IFRS 9);

(c) measurement based on expected cost (IAS 19 – profit-sharing and bonus plans);

(d) measurement based on the portion of the expected entitlement benefit attributable to current and past periods, taking expectations about future assets (including services) yet to be received into account (IAS 19 – defined benefit obligations);

(e) measurement based on expected outflows related to some variables, but expected outflows related to other variables are not reflected (IFRS 16);

(f) measurement at 'the best estimate' (IAS 37); and

(g) measurement based on fulfilment cash flows plus a contractual service margin (IFRS 17 *Insurance Contracts*).

Subsequent measurement of a liability or equity instrument

25 In addition to the differences on how variable and contingent consideration is measured at initial recognition, differences in how liabilities and equity are subsequently measured result in further differences.

26 Some standards require the measurement of the liability to be updated to reflect the circumstances on the reporting date (applying the measurement approach used at initial recognition) (IAS 19, IAS 37, IFRS 2 (cash-settled share-based payment), IFRS 3 (non-equity contingent consideration), IFRS 9 (instruments measured at fair value) and IFRS 17).

27 One standard requires the measurement to be updated to reflect changes in the estimated timing and number of instruments expected to vest, unless it is related to a market condition. Changes in expectations related to market conditions are not subsequently revised. (IFRS 2 (equity-settled share-based payment)).

28 One standard requires the measurement to be adjusted to reflect actual and revised estimated contractual cash flows. However, when discounting the liability, the original effective interest rate should be used for changes that do not result from changes in the interest rate for floating rate instruments (IFRS 9 (amortised cost instruments)).

29 One standard requires the measurement to be adjusted to reflect revisions in the limited cash flows from contingent and variable consideration that were also taken into account at initial recognition (but not other cash flows). In those cases, an unchanged discount rate should be used unless the change in the cash flows results from a change in floating interest rates (IFRS 16).

30 One standard requires that the measurement is not subsequently remeasured (IFRS 3 (contingent consideration classified as equity)).

31 For liabilities that will have to be paid in a currency that is not the functional currency of the entity, exchange rate changes would be an element that would result in the liability being variable. IAS 21 *The Effect of Changes in Foreign Exchange Rates* requires that foreign currency monetary items shall be translated using the closing rate.

Definition and recognition of an asset

32 The issues identified around variable and contingent consideration from the perspective of the party that has to pay the variable or contingent consideration do not arise because of different interpretations of the definition of an asset or differences in Standards on this issue. For some types of variable and contingent consideration, the definition of an asset is nevertheless important as the interviews with audit firms showed that specific characteristics of variable payment may result in the 'transferred' item not meeting the definition of an asset of "the receiving party". Instead the transaction may be a financing transaction or an agent/principal relationship.

33 In addition, the issues identified do not relate to the recognition requirements of an asset, although these are different for different types of assets. The EFRAG Secretariat will, however, include the various relevant recognition requirements in its inventory of relevant requirements. The reason is that some EFRAG TEG members have expressed a preference for 'mirror-accounting' in relation to variable and contingent consideration and current requirements could sometimes result in a buyer recognising and/or measuring a liability for variable and contingent differently from the seller receiving the variable or contingent consideration.

Initial measurement of an asset at cost

34 The preliminary assessment of the EFRAG Secretariat is that most issues with variable and contingent consideration that are related to the measurement of assets are related to assets measured at cost. So far, the EFRAG Secretariat has accordingly focused on those assets. The EFRAG Secretariat, however, acknowledges that issues also exist in relation to, for example, assets measured at a revalued amount. It would also be necessary to consider the requirements for assets measured at another amount than cost in order to identify any mismatches between the measurement of the liability and the asset of one entity and to identify "broken mirror-accounting".

35 Many Standards do not provide much specific guidance on whether or when variable and contingent consideration should be included in the cost price (IAS 16 *Property, Plant and Equipment*, IAS 27 *Separate Financial Statement*, IAS 38 *Intangible Assets*, IAS 40 *Investment Property*, IAS 41 *Agriculture* and IFRS 6 *Exploration and for Evaluation of Mineral Resources*). In one standard, it is, however, noted that trade discounts, rebates and other similar items should be deducted in determining the costs of purchase (IAS 2 *Inventories*).

36 IFRS 16 provides more guidance, but that guidance may not be intended to be applied for other types of assets.

37 For a right-of-use asset, it follows from IFRS 16 that the cost shall comprise variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date (but not other variable lease payments).

Subsequent measurement of assets at cost

38 Standards and official interpretations include what are perceived to be inconsistent requirements on how to reflect changes in variable and contingent consideration in an acquired asset (or assets).

39 IFRIC Interpretation 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* states that changes in the measurement of an existing decommissioning, restoration and similar liability that result from changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation, or a change in the discount rate, shall be added or deducted from the cost of the related asset (a right-of-use asset or an item of property, plant and equipment).

40 On the other hand, changes in the fair value of contingent consideration related to a business combination that is not classified as equity should not affect the carrying amount of the acquired assets. Instead the amount is reported in profit or loss.

41 For a right-of-use asset under IFRS 16, the original cost should subsequently be adjusted for changes in the index or rate reflected in the initial measurement of the asset.

42 IFRS 9 states that adjustments to amortised cost for non-floating-rate financial liabilities are recognised in profit or loss as income or expense. This would mean that for an asset acquired by incurring a non-floating-rate financial liability measured at amortised cost, subsequent changes in the *liability* cannot be reflected in the measurement of the asset (i.e. changes cannot be capitalised). However, it may not prohibit changes in the *estimated cost* to be reflected in the measurement of the acquired asset.

43 IFRS Standards, do, however, not provide guidance on whether changes in the amount to be paid as variable and contingent consideration could be considered as a change in the estimate of the original estimated cost price or as a subsequent event that should not affect the original estimated cost price.

44 Assets are accounted for independently from the related liabilities for the effects of changes in foreign exchange rates. Non-monetary items that are measured in terms of historical cost in a foreign currency are thus translated using the exchange rate at the date of the transaction even when the corresponding monetary liability is translated using the closing rate. Accordingly, exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit or loss in the period in which they arise, except if it forms part of a reporting entity's net investment in a foreign operation.

45 For assets and situations not covered by specific guidance, the interviews with audit firms revealed that practice is inconsistent and is making use of all the different approaches, that is:

(a) not reflecting changes in variable and contingent consideration (or changes in the measurement of the related liability or equity instrument caused by changes in variable and contingent consideration) in the subsequent measurement of the asset;

(b) reflecting some, but not all, changes in variable and contingent consideration (or changes in the measurement of the related liability or equity instrument caused by changes in variable and contingent consideration) in the subsequent measurement of the asset; and

(c) reflecting all changes in variable and contingent consideration (or changes in the measurement of the related liability or equity instrument caused by changes in variable and contingent consideration) in the subsequent measurement of the asset.

46 Some of the factors that are considered by auditors when assessing the best (but not the only acceptable) accounting treatment for a given situation are:

(a) Whether the change in the variable and contingent consideration is under the control of the holder of the asset (if it is, then the measurement is adjusted).

(b) Whether an increase in the consideration is associated with future economic benefits to be derived from the asset.

(c) Whether the liability is accounted for in accordance with IAS 37 (then the measurement of the asset is adjusted following an analogy of IFRIC 1) or is a

financial liability (then the measurement of the asset is not adjusted, but the change is reported in profit or loss).

(d) Whether, in the case the related liability is covered by IFRS 9, the financial liability is a floating rate liability or not.

(e) Whether the change can be considered a change in the accounting estimate of the original cost price.

(f) Whether the variability relates to conditions that existed at the end of the reporting period, but which are adjusted following adjusting events after the reporting period.

47 EFRAG TEG will consider these factors further when discussing alternative solutions to accounting for variable and contingent consideration.

Questions to EFRAG TEG

48 Paragraphs 7 - 10 summarise the information the EFRAG Secretariat has collected by interviewing people working for audit firms about variable and contingent consideration: when it is used, the main industries affected, the most common transactions and arrangements, and what the variability often is linked to. Do EFRAG TEG members have any additions to the lists presented?

49 As noted in paragraph 6(b), the EFRAG Secretariat does not plan to conduct additional interviews in order to understand the issues from an accounting standard perspective related to variable and contingent consideration. Have EFRAG TEG members identified additional issues? If so, does this indicate that further interviews should be conducted in order to have a more complete overview of the issues related to variable and contingent consideration?

50 The summary notes that the EFRAG Secretariat has not yet included relevant IFRS guidance on the definition of an asset, recognition of assets and the measurement of assets, other than those measured at cost, in its inventory of relevant guidance. For the areas already covered in the inventory of relevant guidance, is there IFRS guidance EFRAG TEG members assess should be considered which is not reflected in this paper (an overview of the main guidance included in the inventory is provided in the appendix from paragraph 59 (the text in bold))?

Appendix: Sources of information

Summary of the latest IFRS Interpretation Committee discussions

51 Between 2011 and 2016, the IFRS Interpretation Committee (the 'IFRS IC') discussed a submission on how to address the accounting for variable payments (that depend on the purchaser's future activity) to be made for the purchase of an item of property, plant and equipment or an intangible asset that is not a part of a business combination.

52 The IFRS IC proposed that the fair value (in accordance with IFRS 9 *Financial Instruments*) of contingent payments that do not depend on the purchaser's future activity should be included in the initial measurement of the asset. If the liability would not be a floating rate instrument, subsequent remeasurement of the liability would adjust the cost of the related asset in some circumstances.

53 However, the IFRS IC could not reach a consensus on whether the purchaser must recognise a liability at the date it purchases the asset for variable payments that depend on the purchaser's future activity, or instead recognise such liability only when the related activity occurs. Some members of the IFRS IC were of the view that all variable payments meet the definition of a liability at the date of purchase of the asset. Other members did not think that variable payments that depend on the purchaser's future activity meet the definition of a liability for the purchaser until the related activity occurs.

54 The IFRS IC was also unable to reach a consensus on how the purchaser measures and remeasures such a liability for variable payments.

55 Finally, in March 2016 the IFRS IC re-debated the issue and concluded that the issue was too broad to address within the confines of the existing IFRS Standards. The IFRS IC suggested that the IASB Board should address the accounting for variable payments comprehensively.

56 The IFRS IC received six comment letters to that submission. A majority of the respondents noted that there was a lack of guidance in this area; the issue was widespread and had resulted in significant diversity in practice and that diversity would continue.

Guidance on variable and contingent consideration provided by the audit firms in their accounting manuals

57 The EFRAG Secretariat is examining the guidance related to variable and contingent consideration in IAS 38 *Intangible Assets* and in IAS 16 *Property, Plant and Equipment* provided by major audit firms in their accounting manuals.

58 The examination has, so far, showed:

(a) Not all the audit firms address specifically variable and contingent consideration relation to the acquisition of tangible and intangible assets in their manuals.

(b) In relation to the initial measurement of assets covered by IAS 16, the available guidance in the manuals would include variable and contingent consideration in the initial measurement of the asset at fair value. Following the initial measurement, the guidance indicates that the remeasurement of the liabilities should be recognised in profit or loss, however, it considers capitalisation of the change in the liability to be an option.

(c) In relation to the initial measurement of assets covered by IAS 38, one manual suggests that if variable payments are based on future revenues, then the cost of the intangible asset should be determined on the basis of the agreed minimum payments. The revenue-based payment is not considered a present

obligation and therefore does not form part of the cost of the intangible asset. Accordingly, any additional payment should be expensed as the related sales occur. Another accounting manual notes that where the purchaser can influence or control the crystallisation of the contingent payments or they are wholly dependent on its future activities, the circumstances are difficult to interpret. The manual acknowledges that in practice there are two general approaches: one is to include the fair value of all the contingent payments in the initial measurement of the asset. The other approach is to exclude executory payments from the initial measurement and recognise the variable payments when the obligation event occurs.

Inventory of relevant guidance: Main requirements on variable and contingent consideration included in IFRS Standards

IAS 2 Inventories

59 **Relevant requirements: Requirements related to how 'cost' is determined.**

60 IAS 2 does not define cost, but mentions that the cost of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

IAS 16 Property, Plant and Equipment

61 **Relevant requirements: Requirements related to how 'cost' is determined.**

62 IAS 16, defines cost as the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, e.g. IFRS 2.

IAS 19 Employee Benefits

63 **Relevant requirements: Requirements related to recognition and measurement of liabilities.**

64 When an asset received is the service of an employee, IAS 19 *Employee Benefits* applies unless IFRS 2 *Share-based Payment* applies.

65 When an employee has rendered service to an entity during an accounting period, the entity shall recognise the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service:

(a) as a liability (accrued expense), after deducting any amount already paid. If the amount already paid exceeds the undiscounted amount of the benefits, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund.

(b) as an expense, unless another IFRS requires or permits the inclusion of the benefits in the cost of an asset.

66 The cost should include the expected cost of paid absence to the extent that the employee's service has increase the entitlement to future paid absence.

67 An entity shall recognise the expected cost of profit-sharing and bonus payments when:

(a) the entity has a present legal or constructive obligation to make such payments as a result of past events; and

(b) a reliable estimate of the obligation can be made.

68 A present obligation exists when, and only when, the entity has no realistic alternative but to make the payments. IAS 19 specifies that this requires that:

(a) the formal terms of the plan contain a formula for determining the amount of the benefit;

(b) the entity determines the amounts to be paid before the financial statements are authorised for issue; or

(c) past practice gives clear evidence of the amount of the entity's constructive obligation.

69 The payment may be conditional of employees staying in the entity until a given date. This condition would not affect the fact that the entity has an obligation but would be considered in the measurement of the liability, i.e. the measurement would reflect that some employees are likely to leave.

70 For defined benefit plans, amounts that depend on future actions of the employer and are conditional on future services being delivered by the employee would be recognised (or reflected in the measurement) in many circumstances.

71 The measurement of the liabilities under IAS 19 is updated to reflect the circumstances on the reporting date.

IAS 21 The effects of changes in foreign exchange rates

72 **Relevant requirements: Requirements on translation of foreign currency items and recognition of exchange differences**

73 According to IAS 21, foreign currency monetary items shall be translated using the closing rate. Non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction.

74 Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit or loss in the period in which they arise, except if it forms part of a reporting entity's net investment in a foreign operation.

IAS 27 Separate Financial Statements

75 **Relevant requirements: Requirements related to how 'cost' is determined.**

76 Although IAS 27 allows entities to measure investments in subsidiaries, joint ventures and associates at cost, it does not provide any guidance on how 'cost' should be calculated.

IAS 32 Financial instruments: presentation

77 **Relevant requirements: Requirements related to when a liability exists.**

Settlement in the entity's own equity instruments

78 When an entity uses a variable number of its own equity instruments as a means to settle a contract, the amount of which fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments, such a contract is a financial liability of the entity.

79 A contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability.

Contingent settlement provisions

80 A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer.

81 However, if a part of such a contingent settlement provision is not genuine, the settlement provision does not affect the classification of a financial instrument. Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument.

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

82 **Relevant requirements: Requirements related to recognition and measurement of a liability.**

83 Under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* an item that would meet the definition of a liability should only be recognised as a provision when:

(a) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(b) A reliable estimate can be made of the amount of the obligation.

84 IAS 37 specifies that when it is not clear whether there is a present obligation, a past event should only be deemed to give rise to a present obligation if it is more likely than not that a present obligation exists at the end of the reporting period.

85 An entity shall not recognise a contingent asset, however, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

86 IAS 37 requires provisions to be measured at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. The Standard mentions that when the provision being measured involves a large population of items, the obligation is estimated at the expected value. However, when a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability.

87 Provisions shall be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. Changes should be reported in profit or loss.

IAS 38 Intangible Assets

88 **Relevant requirements: Requirements related to how ‘cost’ is determined.**

89 IAS 38 defines cost as the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, e.g. IFRS 2.

IAS 40 Investment Property

90 **Relevant requirements: Requirements related to how ‘cost’ is determined.**

91 IAS 40 defines cost as the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or

construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, e.g. IFRS 2.

IAS 41 Agriculture

92 **Relevant requirements: Requirements related to how 'cost' is determined.**

93 IAS 41 does not include any particular guidance on how to determine 'cost' in cases the fair value of biological assets cannot be determined reliably.

IFRS 2 Share-based Payment

94 **Relevant requirements: Requirements related to how a liability and equity instrument is recognised and measured.**

95 An entity shall recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognise a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share-based payment transaction.

96 For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received. However, if that fair value cannot be estimated reliably, the equity is measured at its fair value at grant date.

97 Vesting conditions, other than market conditions, shall not be taken into account when estimating the fair value, but shall be taken into account by adjusting the number of awards included in the measurement of the liability arising from the transaction.

98 The measurement of an equity instrument that is recognised following the guidance for equity-settled share-based payment transactions in IFRS 2, is updated to changes in the estimated length of the vesting period unless it is related to a market condition. Changes in expectations related to market conditions is not subsequently revised.

99 For cash-settled share-based payment transaction the entity shall measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity shall remeasure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognised in profit or loss for the period.

IFRS 3 Business Combinations

100 **Relevant requirements: Requirements on contingent consideration.**

101 Contingent consideration shall be measured at fair value at the time of the business combination and is taken into account in the determination of goodwill. If the amount of contingent consideration changes as a result of a post-acquisition event (such as meeting an earnings target), accounting for the change in consideration depends on whether the additional consideration is classified as an equity instrument or an asset or liability:

(a) If the contingent consideration is classified as an equity instrument, the original amount is not remeasured.

(b) If the additional consideration is classified as an asset or liability that is a financial instrument, the contingent consideration is measured at fair value and gains and losses are recognised in either profit or loss or other comprehensive income in accordance with IFRS 9.

102 Where a change in the fair value of contingent consideration is the result of additional information about facts and circumstances that existed at the acquisition date, these changes are accounted for as measurement period adjustments if they arise during the measurement period.

IFRS 6 Exploration for and Evaluation of Mineral Resources

103 **Relevant requirements: Requirements related to how 'cost' is determined.**

104 IFRS 6 provides examples of expenditures that might be included in the initial measurement at cost of exploration and evaluation assets. However, it does not include guidance on how variable and contingent consideration should be reflected in 'cost'.

IFRS 9 Financial Instruments

105 **Relevant requirements: Requirements related to recognition, how a liability is measured and how subsequent changes in the contractual cash flows should be accounted for.**

106 Under IFRS 9 *Financial Instruments* a liability should only be recognised for variable consideration to the extent that it arises from a contract (i.e. constructive obligations should not be recognised under this Standard).

107 Financial liabilities included in the scope of IFRS 9 should initially be measured at fair value.

108 After initial recognition, financial liabilities included in the scope of IFRS 9 are either measured at fair value or at amortised cost. If the instrument is measured at amortised cost, the measurement should be adjusted to reflect actual and revised estimated contractual cash flows. However, when discounting the liability, the original effective interest rate should be used.

IFRS 15 Revenue from contracts with customers

109 **Relevant requirements: Requirements related to recognition of a performance obligation and how to account for variable consideration.**

110 If a customer pays an amount in advance for a product or service of an entity, the entity should recognise a performance obligation in accordance with IFRS 15 *Revenue from Contracts with Customers* when all the following criteria are met:

(a) the parties to the contract have approved the contract;

(b) the entity can identify each party's rights regarding the goods or services to be transferred;

(c) the entity can identify the payment terms for the goods or services to be transferred;

(d) the contract has commercial substance; and

(e) it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services.

111 An entity shall include in the transaction price some or all of an amount of variable consideration estimated using the expected value (sum of probability-weighted amounts) or the most likely amount (the single most likely outcome of the contract), only to the extent that it is <u>*highly probable*</u> that a significant reversal in the amount of cumulative revenue recognised will not occur when the variable situation is resolved.

112 The Standard also specifies that an entity shall estimate an amount of variable consideration by using either the expected value or the most likely amount. The method should be selected that the entity expects to better predict the amount of consideration to which it will be entitled. The Standard states that an expected value

may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics. The most likely amount may be appropriate if the contract has only two possible outcomes. However, the Standard does not provide guidance on which method would be most appropriate if the entity only has one (or few similar contracts) with several possible outcomes.

113 The entity shall update the estimated price transaction (including variable consideration) at the end of the year, accounting for changes in the transaction price as revenue, or as a reduction of revenue, in the period in which this transition price changes.

IFRS 16 Leases

114 **Relevant requirements: Requirements related to how to account for variable and contingent consideration.**

115 If a transaction would fall under IFRS 16, a liability for variable consideration that is in-substance fixed payments or that depend on an index or rate should be recognised. An obligation to pay a variable consideration that would depend on future actions of the lessee should, on the other hand, not be recognised.

116 Under IFRS 16 a lease liability is measured at the present value of the lease payments that are not paid. Variable payments other than payments that are, in substance, fixed payments (but structured as variable payments) and payments that are dependent on an index or a rate excluded from the initial measurement. As a result, variable lease payments that are dependent on the lessee’s future activity are excluded from the initial measurement of the liability (until the activity is performed). For variable lease payments dependent on an index or a rate, the IASB decided to require an entity to determine payments at initial recognition using the index or rate at the commencement date. The decision to not require forecasting techniques to be used in determining payments at initial recognition was based on a cost-benefit assessment.

117 According to IFRS 16, a lease liability should be remeasured by discounting the revised lease payments using a revised discount rate if there is a change in the lease term or changes in the assessment of an option to purchase the underlying asset. The discount rate used in the measurement of a lease liability should accordingly not be updated for the purpose of reflecting the current discount rate. A lessee shall remeasure the lease liability by discounting the revised lease payments if there is a change in the amounts expected to be payable under a residual value guarantee or there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments. In those cases, an unchanged discount rate should be used unless the change in lease payments results from a change in floating interest rates.

118 The requirement in IFRS 16 to only reassess variable lease payments that depend on an index or a rate when there is a change in the cash flows resulting from a change in the reference index or rate was included for cost-benefit reasons. The IASB acknowledged that this requirement provides less relevant information than reassessing lease payments at each reporting date, because a lessee will not remeasure the lease liability to reflect the relevant index or rate at every reporting date.

119 Under IFRS 16, variable lease payments that have not been included in the lease liability (such as those that are based on future activity of the lessee), should be recognised in profit or loss in the period in which the obligation for those payments incurred (unless the costs are included in the carrying amount of another asset in accordance with other applicable Standards).

120 IFRS 16 specifies that the cost of the right-of-use asset shall comprise variable lease payments that depend on an index or a rate, initially measured using the index or

rate as at the commencement date. Similarly, the cost of the right-of-use asset shall comprise an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.

IFRS 17 Insurance Contracts

121 **Relevant requirements: Requirements related to recognition and measurement of a liability.**

122 A liability related to an issued insurance contract is recognised in accordance with IFRS 17 at the beginning of the coverage period of the group of contracts, or, if earlier:

(a) The date on which the first payment from a policy holder in the group becomes due;

(b) For a group of onerous contracts, when the group becomes onerous.

123 The liability component of an insurance contract is therefore recognised even if the contract is executory when the coverage period has not started and the first payment is due, but unpaid.

124 Under IFRS 17 a group of insurance contracts should be measured at:

(a) the fulfilment cash flows, which comprise:

(i) estimates of future cash flows;

(ii) an adjustment to reflect the time value of money and the financial risks related to the future cash flows, to the extent that the financial risks are not included in the estimates of the future cash flows; and

(iii) a risk adjustment for non-financial risk.

(b) the contractual service margins.

125 Under IFRS 17, the measurement of the liability related to a group of insurance contracts is updated to reflect the fulfilment cash flows estimated at the reporting date, the changes in the contractual service margin following from the recognition in profit or loss and the liability for incurred claims.

IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities

126 IFRIC 1 addresses how to account for changes in the measurement of an existing decommissioning, restoration and similar liability that results from changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation, or a change in the discount rate.

Related asset is measured using the cost model

(a) Changes in the liability shall be added to, or deducted from, the cost of the related asset in the current period.

(b) The amount deducted from the cost of the asset shall not exceed its carrying amount. If a decrease in the liability exceeds the carrying amount of the asset, the excess shall be recognised immediately in profit or loss.

(c) If the adjustment results in an addition to the cost of an asset, the entity shall consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable. If it is such an indication, the entity shall test the asset for impairment by estimating its recoverable amount, and shall account for any impairment loss, in accordance with IAS 36.

Related asset is measured using the revaluation model

(a) Changes in the liability alter the revaluation surplus or deficit previously recognised on that asset, so that (i) a decrease in the liability shall be recognised in other comprehensive income and increase the revaluation surplus within equity, except that it shall be recognised in profit or loss to the extent that it reverses a revaluation deficit on the asset that was previously recognised in profit or loss; (ii) an increase in the liability shall be recognised in profit or loss, except that it shall be recognised in other comprehensive income and reduce the revaluation surplus within equity to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

(b) In the event that a decrease in the liability exceeds the carrying amount that would have been recognised had the asset been carried under the cost model, the excess shall be recognised immediately in profit or loss.

(c) A change in the liability is an indication that the asset may have to be revalued in order to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period. Any such revaluation shall be taken into account in determining the amounts to be recognised in profit or loss or in other comprehensive income. If a revaluation is necessary, all assets of that class shall be revalued.

127 The adjusted depreciable amount of the asset is depreciated over its useful life. At the end of the related asset's useful life, all subsequent changes in the liability shall be recognised in profit or loss as they occur.

128 The periodic unwinding of the discount shall be recognised in profit or loss as a finance cost as it occurs. Capitalisation under IAS 23 is not permitted.

IFRIC 12 Service Concession Arrangements

129 IFRIC 12 applies to public-to-private service concession arrangements where the grantor controls or regulates the type, recipient and price of services, and any residual interest in the infrastructure at the end of the term of the arrangement.

130 Construction or upgrade services – The consideration received or receivable by the operator shall be recognised at its fair value, and may be rights to a financial asset or an intangible asset:

(a) The operator shall recognise a financial asset to the extent that the operator has an unconditional contractual right to receive (a) specified or determinable amounts or (b) the shortfall, if any, between amounts received from users of the public service and specified or determinable amounts, even if payment is contingent on the operator ensuring that the infrastructure meets specified quality or efficiency requirements. The grantor has little, if any, discretion to avoid payment.

(b) The operator shall recognise an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.

131 Operation services – The operator shall account for operation services in accordance with IFRS 15. Any contractual obligations to maintain or restore the infrastructure to a specified level of serviceability, except for any upgrade element, shall be recognised and measured in accordance with IAS 37, i.e. at the best estimate of the expenditure that would be required to settle the present obligation at the balance sheet date.

132 Infrastructure items to which the operator is given access by the grantor for the purposes of the service arrangement are not recognised as property, plant and equipment of the operator. The grantor may also provide other items to the operator

that the operator can keep or deal with as it wishes. If such assets form part of the consideration payable by the grantor for the services, they are accounted for as part of the transaction price as defined in IFRS 15.