DISCUSSION PAPER

VARIABLE CONSIDERATION

[MONTH AND YEAR OF PUBLICATION]

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- engaging with European constituents to understand their issues and how financial reporting affects them;
- influencing the development of International Financial Reporting Standards ('IFRS Standards');
- providing thought leadership in developing the principles and practices that underpin financial reporting; and
- promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our research work and current projects is available on the EFRAG website.

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CHAPTER 1: BACKGROUND

Variable consideration in use

1.1 In many transactions, the consideration to be paid is not a fixed amount. Instead the amount to be paid — in cash or by transferring a non-cash asset — varies with factors related to the asset, to one of the parties in the transaction and/or to something unrelated to these. Variable consideration can be introduced for many different purposes. Some examples are provided below.

a) When the **quality of an asset** including how much profit it can generate is unknown at the date of the transaction, the consideration could be variable to reflect the quality of the asset as it will become apparent. For example, a seller of a plot of land which contain an unknown amount of gold could find it difficult to sell the land at a price reflecting the seller's (optimistic) estimates of the amount of gold available. In order to attract more pessimistic buyers, it could therefore be agreed that the price of the plot of land would depend on how much gold the buyer would find on the land. Similarly, if there is uncertainty about how much profit an asset can generate, either the buyer or the seller can diversify risk by variable consideration. For example, a seller can diversify risk by selling an asset at a discount but retaining a right to additional consideration if the income generated by the asset exceeds a certain threshold. Similarly, a buyer can diversify risk by agreeing that the consideration to be paid in return for the asset should depend on the income generated from the asset.

b) When a seller wants to **stimulate sales**, the consideration of all the goods a particular buyer buys within a year could vary with the total number of goods purchased within a year.

c) When one party wants to **retain some of the risks and rewards** related to an asset, but cannot afford to maintain and/or develop the asset, that party can transfer the asset to another party in return for a consideration that will depend on the performance of the asset transferred (or the further developed asset).

d) When a buyer does not trust the **seller's estimate of the value** of an asset, the consideration to be paid in return for the asset could be set to vary depending on the income generated from the asset or on the outcome of a due diligence carried out by the buyer.

What are the accounting issues with variable consideration?

1.2 When accounting for variable consideration, one of the first issues that arises is what the transaction is about — that is, what is exchanged? If one entity is receiving the right to use an asset, but has to pay a consideration based on the profit made by using the asset, is the transaction a transfer of the asset, or something else?

1.3 When it has been established what the transaction is about — that is, what assets (including services) that have been transferred — the next question is then how the variable and contingent consideration should be accounted for in relation to any obligation to transfer a consideration and in relation to the measurement of the asset received.

1.4 For some types of transactions, IFRS Standards include some guidance on how to account for variable consideration by the party that will have to pay the consideration. This is the case for business combinations under IFRS 3 *Business Combinations*, leases under IFRS 16 *Leases*, financial instruments under IFRS 9 *Financial Instruments* and provisions and contingent liabilities under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In addition, guidance is provided in IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* and IFRIC 12 *Service Concession Arrangements*. IFRS 15 *Revenue from Contracts with Customers* provide some guidance on how to account for variable consideration (to be) received.

1.5 The problem with the existing guidance is that it is incomplete and inconsistent. For example:

a) IAS 37 and IFRS 9 could result in a liability to pay a variable consideration being accounted for differently, depending on which standard the variable consideration would be covered by.

b) There is not guidance on whether, and if so how, the cost price of an asset acquired outside a business combination should be updated to reflect changes in variable consideration to be paid.

Discussions on variable consideration by the IFRS Interpretations Committee

1.6 In September and November 2015, the IFRS Interpretations Committee ('the Interpretations Committee') discussed the accounting for variable payments for the purchases of PPE and intangible assets outside of a business combination. The Interpretations Committee discussed this issue over several meetings between 2011 and 2013, but decided to resume the discussions once the proposals on lease accounting and the Conceptual Framework had been published.

1.7 In September 2015, the Interpretations Committee received a request to clarify the accounting for variable contractual payments that are to be made by an operator to a grantor under a service concession arrangement accounted for under the intangible asset model within the scope of IFRIC 12 Service Concession Arrangements.

Variable payments for the purchases of PPE and intangible assets

1.8 The Interpretations Committee observed that the issue affected several industries and that different forms of variable payments were used in PPE and intangible asset acquisitions. The issue was less common for the acquisition of inventories. The following examples were discussed:

1.9 Variable (contingent) payments may depend on the purchaser's future activity derived from the underlying asset (such as payments based on sales, revenues or outputs produced). These variable payments are also common in licence agreements. For example, a contract for the purchase of an intangible asset (such as a licence) may state that the payments are based on a specified percentage of sales made from using the licence. Other examples include variable payments that are made if the purchaser reaches a specific milestone when using the asset purchased in a research and development project. These payments are common, for example, at various stages of the research and development of a new drug in the pharmaceutical industry.

1.10 Variable (contingent) payments that are made if the asset acquired complies with agreed-upon specifications at specific dates in the future (such as a standard production capacity or a standard performance). These are payments that the purchaser will make if the asset acquired is capable of providing, at specified dates in the future, a specified performance agreed with the seller. If the asset is not capable of providing the agreed performance, payments are reduced or not made. These payments are not dependent on the purchaser's future activity.

1.11 Variable payments that are dependent on an index or a rate (such as LIBOR, inflation or the consumer price index). These variable payments are common in licence agreements with the amount increasing at the end of each year based on the consumer price index or some other index or rate.

1.12 The Interpretations Committee could not reach a consensus on whether the variable payments that depend on the purchaser's future activity should be recognised in the statement of financial position of the purchaser as a liability until that activity is performed and what the initial measurement of this liability should be.

1.13 Some members of the Interpretations Committee were of the view that all variable payments met the definition of a liability and should be initially recognised and measured at fair value.

1.14 Other members did not think that variable payments that depend on the purchaser's future activity met the definition of a liability for the purchaser, until the activity occurs.

1.15 The Interpretations Committee considered the additional concepts proposed for the definition of a liability in the Conceptual Framework Exposure Draft (published in May 2015) and also observed that during the deliberations on the proposals in the Exposure Draft Leases, members of the IASB had expressed mixed views on whether variable payments linked to future performance or use of the underlying asset in a lease met the definition of a liability. Some members of the IASB did not think that such payments met the definition of a liability for the lessee until the performance or use occurs while other members were of the view that all variable lease payments met the definition of a liability for the lessee. The Interpretations Committee noted that the IASB did not conclude on whether these variable payments met the definition of a liability.

1.16 The Interpretations Committee observed that the issue was too broad for the Interpretations Committee to address within the confines of existing IFRSs and consequently decided not to add this issue to its agenda.

Variable contractual payments under a service concession arrangement

1.17 When discussing how to account for variable contractual payments that are to be made by an operator to a grantor under a service concession arrangement accounted for under the intangible asset model within the scope of IFRIC 12, the Interpretations Committee noted that it had previously decided that the accounting for variable payments for asset purchases was too broad an issue for the Interpretations Committee to address (see paragraphs above).

1.18 Consequently, the Interpretations Committee considered whether a solution could be developed to address the accounting for payments made by an operator to a grantor without the need to address the broader issue of variable payments for asset purchases. However, members of the Interpretations Committee expressed mixed views on this approach. Some members were of the view that the issue could not be addressed without addressing the broader issue of accounting for variable payments for asset purchases. Other members were of the view that service concession arrangements represent a unique type of arrangement that shares some characteristics with lease contracts. These members were of the view that the Interpretations Committee could consider developing guidance by utilising principles similar to those developed by the IASB for the accounting for variable payments in lease contracts.

1.19 On balance the Interpretations Committee concluded that the issue was also too broad for it to address.

Accounting Firm guidance

1.20 There is notable variation in the accounting guidance suggested in the accounting manuals published by accounting firms on variable (contingent) consideration. This was confirmed by previous research undertaken by the IFRS Interpretations Committee (September 2015), which informed that there was no consistent approach to account for variable payments for asset purchases. While predominant approaches may exist for certain industries and/or within certain jurisdictions, significant diversity continues to exist in the following areas:

a) recognition of variable payments on initial purchase of the asset; and

b) recognition of subsequent adjustments to variable payments.

1.21 While accounting firm guidance generally support recognition of variable consideration as a liability, some firms highlight that in some cases the variable consideration does not meet the definition of a liability. For example, some accounting firms argue that revenue-based variable payments are not a present obligation and therefore do not meet the definition of a liability.

1.22 For variable payments related to the purchase of an intangible asset, one accounting firm believes that if the 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 asset. Accordingly, any additional payments should be expensed in profit or loss as the related sales occur.

1.23 However, another accounting firm acknowledge that in practice there are two general approaches when accounting for contingent consideration related to intangibles assets. “One includes the fair value of all contingent payments in the initial measurement of the assets. The other excludes executory payments from initial measurement. Under both approaches, contingent payments are either capitalised when incurred if they meet the definition of an asset, or expensed as incurred.” This accounting firm also highlights that the issue of contingent consideration has been considered by the IFRS Interpretations Committee, which separated cost into two types according to whether or not they depend on the buyer’s future activity. The Committee proposed that the fair value of contingent payments that do not depend on the purchaser’s future activity should be included in the initial measurement of the asset.

1.24 The same accounting firm believes that a financial liability relating to variable consideration arises on the purchase of an item of PP&E and any measurement changes to that liability would be recorded in the statement of profit or loss as required by IFRS 9 *Financial Instruments*.

1.25 However, this accounting firm notes that in some instances contracts are more complex and it can be argued that the subsequent changes to the initial estimate of the purchase price should be capitalised as part of the asset value, similar to any changes in a decommissioning liability recorded under IFRIC 1. They suggest that an entity should develop an accounting policy for variable consideration relating to the purchase of PPE in accordance with hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. An entity should exercise judgement in developing and consistently applying an accounting policy that results in information that is relevant and reliable in its particular circumstances.

1.26 The guidance on variable consideration provided by other accounting firms is generally consistent with that of the two accounting firms mentioned above.

Scope and objective of this Discussion Paper

1.27 The focus on this Discussion Paper is how to account for variable consideration when it has been clarified what assets are transferred in a transaction. The discussion paper by the FRC *[INSERT TITLE WHEN FRC PAPER HAS BEEN FINALISED]* includes discussions on what asset is acquired in different types of variable consideration transactions.

1.28 The focus of the Discussion Paper is the accounting issues from the perspective of the entity that will have to pay a variable consideration. However, as some consider that the accounting treatment of the entity that is paying variable consideration should mirror how the variable consideration is accounted for by the entity that is receiving the consideration, the vendor's perspective is also considered when relevant.

1.29 The Discussion Paper is not limited to variable consideration (to be) paid in cash. It thus also covers situations under which an entity will have to transfer another (non-cash) type of asset(s) – including providing a service – in the exchange. This means that although the Discussion Paper focuses on the entity that has to provide a variable consideration, the related obligation could be a performance obligation under IFRS 15.

1.30 While the Discussion Paper often refers to the asset or an asset acquired in exchange for a variable consideration, the Discussion Paper is not limited to transactions in which an asset is acquired separately. The Discussion Paper thus also covers variable consideration to be paid for a group of asset/a business. The Discussion Paper, however, only considers the issues related to how to account for variable consideration in those cases.

1.31 The Discussion Paper is not limited to transactions under which 'the buyer' will receive an asset that is measured at cost at initial recognition and subsequently. However, not all the issues covered by this Discussion Paper are relevant to assets that are not measured at cost.

1.32 The Discussion Paper only considers transactions that are carried out on market terms.

Definition of variable consideration

1.33 The Discussion Paper considers that a consideration is variable, unless the payment as specified in the agreement (in an amount of any currency or a number of/an amount of other items – including services - of a specified quality) to be transferred in returned for a good or services is fixed. Variable consideration includes consideration that is contingent on future events.

1.34 The definition means that the following considerations to be provided in return for a specified item would be considered to be fixed and would thus not be covered by this Discussion Paper. (Chapter 7 would cover value changes of the obligations related to those considerations):

a) A fixed amount of a foreign currency;

b) A fixed number of own equity instruments;

c) A fixed quantity of a specified item (goods or services).

1.35 On the other hand, the following considerations to be provided in return for a specified item would be considered to be variable, and would thus be covered by this Discussion Paper:

a) An amount in any currency that would vary depending on factors both within and outside the control of the receiving entity;

b) An amount in any currency corresponding to the market value of the receiving entity's own equity instruments;

c) An amount in any currency corresponding to the market value of a given item.

Issues considered

1.36 This Discussion Paper considers five issues related to variable consideration. In addition, the Discussion Paper considers value changes of the consideration to be transferred that are not considered as resulting from the consideration being variable in accordance with the definition of variable consideration provided in paragraph 1.33 above. This includes, for example, changes in the measurement of an obligation to transfer a fixed amount in a foreign currency. As noted above, the transfer of a fixed amount in a foreign currency is not considered to be variable consideration, but the fact that the amount is translated at the balance sheet date into the entity's functional currency for the preparation of the financial statements, results in changes in the measurement of the obligation.

1.37 The issues considered are explained below.

a) From the perspective of a buyer, the first thing that has to be made clear is whether the buyer has a liability in relation to a variable consideration.

b) If the buyer has a liability, the next issue is how to measure this liability (including updating the measurement following changes in (the estimation of) the variable consideration.

c) If the buyer has a liability in relation to the variable consideration, another issue is how this liability (and changes in this) should be reflected in the measurement of the asset (to be) received in exchange for the consideration (or in the statement of comprehensive income).

1.38 This Discussion Paper considers whether a buyer has a liability in relation to the variable consideration by first discussing whether an obligation to pay a variable consideration should be considered to be a separate unit of account and if so, whether this would meet the definition of a liability in the *Conceptual Framework for Financial Reporting*.

Determining the unit of account

1.39 When a consideration includes both a variable and a fixed component, it is necessary to determine the unit of account for recognition and measurement. The issue is whether a variable component of a consideration that will depend on future actions or events should be considered as a separate unit of account in relation to recognition and measurement, or as part of a single unit of account that also includes a fixed consideration. There does not seem to be diverging views as to whether any fixed part of a consideration that would have to be transferred in exchange for an item received 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) is (are) considered to be a separate unit of account, divergent views exist as to whether these components would meet the definition of a liability.

Recognising a liability

1.40 The second issue is whether or when a variable consideration should be recognised including whether it would meet the definition of a liability included in the *Conceptual Framework for Financial Reporting*.

The cost and recognition issue

1.41 The third issue is the cost and recognition issue. The purchase price – often referred to as the cost of an asset - is not always fixed and in many cases includes a variable component. Current IFRS Standards and IFRS Interpretations provide limited guidance on how to determine cost when the transaction price includes variable consideration.

Buyers perspective

1.42 The accounting issue is whether and in which cases variable consideration included in the transaction price should be included in the cost of an asset when an asset is transferred to a buyer and recognised under IFRS Standards. The issue can apply across a broad range of assets, including items of PPE, intangible assets, real estate assets and financial assets. In this DP this issue is referred to as ‘the cost and recognition issue’.

1.43 Current IFRS Standards are not clear about whether the cost of an asset should include amounts other than fixed consideration. Although some guidance exists in some IFRS Standards, it is not consistent. The diversity arises at initial recognition of the asset and in subsequent periods. The IFRS Interpretations Committee has discussed variable payments for the purchases of PPE and intangible assets in 2013 and again in 2015 (see paragraphs 1.6 to 1.19) but decided not to add the issue to its agenda. The Interpretations Committee noted that the issue was too broad and should be addressed by the IASB is a separate project covering variable payments.

1.44 The *Conceptual Framework for Financial Reporting* provides information on what comprises historical cost and when an item meets the definition of an asset and should be recognised in the statement of financial position. However, the Framework does not discuss the relationship between the recognition and measurement of an asset and a related liability. For example, there is little guidance about how to account for the "debit" side of a transaction when a liability is recognised - is the 'debit' an asset that needs to be recognised on the balance sheet or an expense?. The Framework examines the existence (in the context of recognition) and measurement of a liability and an asset as separate units of account. However, at IFRS Standards-level there might be exceptions to this general concept.

Seller's perspective

1.45 An issue could arise from the perspective of the seller when the transaction price includes variable consideration. The question is when to derecognise the asset being transferred and the amount of revenue to recognise. The accounting for revenue arising from contracts with customers is addressed under IFRS 15. However, for a sale of PPE, outside the scope of IFRS 15, IAS 16 provides limited guidance. In practice, there could be different derecognition treatments. For example:

a) View 1 - The seller's right to variable consideration could be measured with reference to the IFRS 15 guidance on the transaction price and recognised as part of the proceeds on sale of the asset on transfer of control.

b) View 2 - The seller's right to variable consideration should be recognised and measured at some other point (for example, when the conditions associated with the variability are met and amounts are receivable).

1.46 **This DP does not specifically address the accounting from the perspective of the seller. However it draws on the principles in IFRS 15 to identify whether they are relevant to the accounting by the buyer.**

1.47 A more detailed analysis of this issue is provided in **chapter 5** of this DP.

The inconsistent measurement issue –initial measurement of a liability for variable consideration and impact on initial measurement (cost) of the acquired asset

1.48 The fourth issue is the inconsistent measurement issue. **Current IFRS provide different accounting requirements for initial measurement of a liability subject to variable consideration**. This could affect the initial measurement of the acquired asset.

1.49 For example:

a) Some IFRS Standards require that to the extent the related asset is measured based on the measurement of the liability, the amount of variable consideration that is recognised as a liability, is also recognised as part of the cost of the asset. However the issue could be that IFRS Standards provide different measurement guidance for liabilities and consequently assets with similar economic transactions would also be measured differently - for example a liability is measured differently under IAS 37 and IFRS 9. This could mean that similar assets, or assets with similar economic characteristics, would be measured differently.

b) Other IFRS Standards require that to the extent the related item acquired (and recognised as an asset) is measured independently of the liability, the difference between the measurement of the liability and the asset would be recognised in profit or loss. This accounting treatment could apply to initial and subsequent measurement, or apply only to subsequent measurement. Some might question whether it is appropriate to recognise an expense/income when an asset is acquired (initially or subsequently or both).

1.50 A more detailed of this issue is provided in **Chapter 4** of this DP.

The asset measurement update issue – subsequent measurement of the asset acquired subject to variable consideration

1.51 There is limited IFRS guidance **on whether, and if so how, the cost of an asset acquired outside of a business combination should be updated to reflect changes in variable consideration related to the asset**. Furthermore the guidance is inconsistent and may not be intended to be applied by analogy for other areas. In this DP this issue is referred to as 'the asset measurement update issue'.

1.52 The amount of a variable consideration liability could change because of the following:

a) Changes in the estimate of the amount or timing of expenditure required to settle the liability (for example when an agreed performance target is met);

b) Changes in the discount rate;

c) Changes in foreign currency exchanges rates (in case the liability is denominated in a foreign currency). This DP does not consider foreign currency transactions covered by IAS 21 *Foreign Currency Transactions* as variable consideration.

1.53 The *Conceptual Framework* does not specifically address remeasurement of assets and liabilities. As mentioned in **paragraph 5.5** the *Conceptual Framework* does not specifically prohibit the use of a hybrid measurement basis (such as a modified cost measurement basis) which could be used to adjust the cost for variable consideration in subsequent periods.

1.54 In its current project on the accounting for rate-regulated activities, the IASB has tentatively decided to apply a *modified historical cost approach* to measure regulatory assets and regulatory liabilities in subsequent periods. Applying this method, the historical cost measurement basis is modified to update it for changes in estimates of future cash flows. In reaching this decision the IASB staff paper (agenda paper 9C, June 2019) noted that:

We understand that updating estimates of future cash flows could be argued by some as not representing (strictly) a historical cost measurement basis. However, paragraphs 6.7–6.8 of the Conceptual Framework indicate that the historical cost of an asset or a liability is updated over time to depict, if applicable, changes such as payments received or made, accrual of interest, and the effects of events that cause all or part of an asset to be no longer recoverable (impairment).

1.55 This DP draws on the thinking of the IASB in recent standard-setting efforts where reference is made to the revised Conceptual Framework issued in March 2018.

1.56 A more detailed of this issue is provided in **Chapter 6** of this DP.

The value change issue

1.57 The last issue is the value change issue. This issue is whether and how to account for value changes of the consideration to be transferred, when there is a time lag between the agreement of the consideration and the transfer, in circumstances where the value change would not be considered as variable consideration as defined in this Discussion Paper. In this discussion paper this is referred to as 'the value change issue'.

1.58 For example, if it is agreed to transfer one kilo of gold in 30 days (which following the definition of variable consideration applied in this discussion paper, is not considered to be variable consideration), the price of the gold would likely change during those 30 days.

CHAPTER 2: DETERMINING THE UNIT OF ACCOUNT

Description of issue

2.1 As mentioned above in Chapter 1, whether or not a liability related to variable consideration exists may depend on whether a variable component of a consideration should be considered as a separate unit of account in relation to recognition and measurement, or as part of a single unit of account including any fixed consideration.

2.2 For example, if an entity has received an energy-efficient asset on 1 January 2020, and in return would have to pay CU 1 000 + 10% of the realised energy savings on 31 December 2022, whether or not the entity has an obligation on 1 January 2020 related to the variable payment could depend on whether the fixed amount and the variable amount are a single unit of account for recognition purposes or they are two unit of accounts. If it is one unit of account, most people would probably agree that the entity has a liability. How to account for the variable part is then a measurement issue (e.g. the variable part could be measured based on the best estimate of the expected energy savings or on the basis of something else). On the other hand, if the obligation to pay CU 1 000 and 10% of the realised energy savings are considered to be two different units of account, different views would exist on whether the entity has a liability related to the variable part and accordingly whether the variable part should be included in the liabilities at all. The views on whether the variable part in the specific example will meet the definition of a liability or not will like depend on further description of facts and circumstances. Such a description will not be provide here as the issue will be considered further in **Chapter 3**.

2.3 In principle, all variable considerations could be separated into a variable component and a fixed component. For example, it might be argued that the price of an equity instrument could be separated into a fixed part (which could be the par value) and a variable part (which would then be the difference between the market price and the par value). In this chapter, however, when a given factor can both result in the total amount being higher or lower than the fixed amount, the entire amount will be considered variable.

2.4 This chapter thus only considers the cases under which an entity would have to pay a positive fixed amount, but the total amount can be either higher or lower as a result of a variable component which can only affect the total amount in one direction (either positive or negative) compared to the fixed amount.

2.5 The limitation above has the (unfortunate) consequence that if a payment is to be regulated by (or indexed to) the development in the consumer price index, the entire amount is considered variable. However, if a payment is only adjusted in the case of an increase in the consumer price index, the amount is considered to consist of both a fixed and a variable part.

2.6 The limitation has been adopted to exclude from the scope of this discussion paper how to determine what should be considered to be the fixed amount and what should be the variable amount. Such a distinction could be important if the variable component would be considered as a separate unit of account and accounted for differently than the fixed amount.

2.7 For example, consider the following contracts (agreed on 1 January 2020):

a) Contract A: Under this contract Entity A receives an asset on 1 January 2020 and will have to pay on 1 January 2021 a consideration based on the following formula: CU 200 + 0.1*(number of units produced – 2 000).

b) Contract B: Under this contract Entity A receives an asset on 1 January 2020 and will have to pay on 1 January 2021 a consideration based on the following formula: 0.1 * number of units produced.

2.8 The two contracts would result in the same economic outcome, but could be accounted for differently *if* the fixed amount in the first contract would be considered to be CU 200 and the fixed amount in the second contract would be CU 0.

2.9 On the other hand, the following two contracts could result in different economic outcome (if the consumer price index would decrease):

a) Contract C: Under this contract Entity A receives an asset on 1 January 2020 and will have to pay on 1 January 2021 CU 100 a consideration based on the following formula: CU 200 + 0.1*max{(number of units produced – 2 000);0}.

b) Contract D: Under this contract Entity A receives an asset on 1 January 2020 and will have to pay on 1 January 2021 a consideration based on the following formula: 0.1 * number of units produced.

Differences in guidance

2.10 The existing standards (including their basis for conclusions) that are relevant in this regard do normally not explicitly specify the unit of account for recognition and measurement although it may appear implicitly. IFRS 9 and IFRS 17 are exceptions. In the Basis for Conclusions to IFRS 17 it is specified that the unit of account to which the requirements in the standard should be applied is a group of insurance contracts. In IFRS 9 it is specified in the Basis for Conclusions that the contract is the unit of account. In other standards, the unit of account may appear implicitly or be difficult to identify.

2.11 Guidance on how to set the unit of account was not included in the *Conceptual Framework for Financial Reporting* until the revision in 2018. The guidance is considered in the section Users' information needs below. In relation to how the unit of account is set differently in different standards, it may, however, be noted that the purpose of the guidance included in the Framework is not that the unit of account should be set similarly in all IFRS Standards. Accordingly, the guidance would not result in all obligations for variable amounts to be distinct from obligations for fixed amounts in all cases, or that in all cases no distinction would be made.

2.12 Current IFRS Standards differ in relation to whether an obligation for a variable amount is considered as a separate unit of account for recognition and/or measurement purposes.

2.13 As mentioned above, in IFRS 17, the unit of account is a group of insurance contract. Accordingly, IFRS 17 does not include specific recognition and measurement requirements for how to account for a variable component versus a fixed component of consideration the entity would have to pay on an insurance contract.

2.14 This is also not the case for a (defined benefit) pension obligation. Under IAS 19, the pension obligation is measured (and recognised) without considering fixed and variable components separately.

2.15 This also seems to be the approach in IAS 37. IAS 37 provides guidance for both provisions and contingent liabilities. A provision is defined as a liability of uncertain timing or amount. The standard does not explicitly consider whether a provision can consist of a fixed element and a variable element, however, this seem to be a possibility. Both in relation to recognition and in relation to measurement, the variable and fixed component would in such cases be addressed as a single unit of account in the standard. A contingent liability is defined in IAS 37 as:

a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

2.16 Under a) and b) (i) the item seems to consist of only a variable component. Under b) (ii) the obligation could, in principle, consist of both a variable and a fixed component. However, the component would not be accounted for differently.

2.17 Also, IFRS 15 (when measuring a performance obligation) does not consider a variable component separately for recognition and measurement. Although IFRS 15, considering the revenue and asset side, notes that a consideration can include a variable amount (FRS 15 paragraph 50), it states that when this is the case, an entity shall estimate the (total) amount of consideration to which it will be entitled in exchange for transferring the promised goods or services to a customer. Accordingly, IFRS 15 does not consider the variable amount as a separate unit of account in relation to recognition and measurement, but the presence of variable amount results in the entire consideration being considered variable in relation to measurement.

2.18 On the other hand, IFRS 3 includes separate guidance for contingent consideration. Among other things, IFRS 3 states that an "acquirer shall classify an obligation to pay contingent consideration that meets the definition of a financial instrument as a financial liability or as equity on the basis of the definitions of an equity instrument and a financial liability in paragraph 11 of IAS 32 Financial Instruments: *Presentation*" (IFRS 3, paragraph 40). In IFRS 3, a contingent consideration element thus seems to be considered as a separate unit of account for both recognition and measurement.

2.19 Similarly, IFRS 16 *Leases* seems to reflect that variable lease payments that do not depend on an index or a rate should not be considered together with fixed lease payments. That is, those variable lease payments are considered a separate unit of account. While some IASB members may have decided to account for those variable lease payments separately for cost reasons, other IASB members noted that variable lease payments linked to future performance or use do not meet the definition of a liability for the lessee, until the performance or use occurs[*].

[*] Agenda Paper 02A for the November 2015 meeting of the IFRS Interpretations Committee.

2.20 This is also the case under IFRS 2. Under an equity-settled share-based payment transaction, the variable consideration part will, following the definition of variable consideration applied in this paper, be the number of equity instruments to be provided. When additional equity instruments are provided as a result of additional goods or services being received, this consideration is accordingly fixed. However, when an employee is granted share options conditional upon the achievement of a performance condition, IFRS 2 includes particular requirements on how to account for these. Accordingly, in this case IFRS 2 seems to consider the variable component as a separate unit of account.

2.21 As mentioned above, under IFRS 9, the unit of account is the contract. However, there is an exception for embedded derivatives. In some cases under which the variability would not be specific to a party to the contract, this could result in the contract being split into a fixed consideration part and a variable consideration part. Generally, however, IFRS 9 would not split an obligation to pay a variable consideration into a fixed part and a variable part.

2.22 Following the definition of variable consideration applied in this paper, the variable part in cash-settled share-based payment is the amount that will have to be paid in cash. Accordingly, a cash-settled share-based payment would normally be (almost) completely variable (and would hence not include a fixed component).

Users' information needs

2.23 [This section will consider the guidance in the *Conceptual Framework for Financial Reporting* on the unit of account].

Accounting alternatives

2.24 [Currently, it is expected that this section will consider the three alternatives (and ask for constituents' view on these:

a) There should be an overarching principle that a (possible) obligation related to variable amounts should always be considered as a separate unit of account (distinct from a fixed consideration);

b) There should be an overarching principle that (possible) obligations related to variable amounts that meet certain criteria should always be considered as a separate unit of account (distinct from a fixed consideration).

c) There should not be any overarching principles for whether (possible) obligations related to variable amounts should be considered as separate units of account (separate from obligations related to fixed amounts). However, each IFRS standard should specify the unit of account in order to avoid divergence in practice.]

Presentation and disclosure proposals

2.25 [Currently, this section is not assessed to be relevant for the unit of account issue]

CHAPTER 3: RECOGNISING A LIABILITY

Description of issue

3.1 For variable consideration to be recognised under current IFRS Standards, it must meet the recognition criteria (if any) in the relevant standards. If a consideration would include a fixed component and a variable component, a liability would be recognised under current IFRS Standards unless the amount of the obligation cannot be measured with sufficient reliability (IAS 37.10) and the obligation would not be covered by another standard than IAS 37. This Chapter accordingly only considers obligations that do not include a fixed component. The Chapter also considers the variable component of a consideration including both a fixed and a variable component if the variable component is considered as a separate unit of account (see Chapter 2). In the latter case, the variable component could potentially be an asset/negative liability (e.g. in the case it represents a volume discount).

3.2 The Conceptual Framework for Financial Reporting was revised in 2018. The revision included amendments to the definition of a liability. Future developments in IFRS Standards would consider this new definition. In addition to considering the requirements in existing IFRS Standards for the recognition of a liability for a variable consideration, this chapter discusses under what circumstances a (possible) obligation to pay variable consideration would meet the definition of a liability.

Differences in guidance and reasons for that

3.3 [This section is expected to include a discussion of the current requirements for recognising variable consideration]

The definition of a liability

3.4 [This section is expected to include a discussion on when a (possible) obligation to pay variable consideration would meet the definition of a liability would be met and questions to constituents on this]

CHAPTER 4: THE COST AND RECOGNITION ISSUE

Is variable (contingent) consideration an element of the cost of an asset?

4.1 The actual purchase price – often referred to as the cost of an asset - is not always fixed and in many cases includes a variable component. Current IFRS Standards and IFRS Interpretations provide limited guidance on how to determine cost (of an item of PPE or an intangible asset) when the transaction price includes variable consideration.

4.2 As explained in paragraphs 1.43 to 1.45 there is diversity in practice about whether the cost of an asset should include amounts other than fixed (known) consideration. Paragraphs 4.40 to 4.46 discusses different possible options on how to account for variable consideration for an asset purchase.

4.3 This section draws on guidance in applicable IFRS Standards regarding the accounting for variable consideration and whether it is part of the cost of the item purchased.

Applicable IFRS Standards and differences in the requirements

4.4 IFRS Standards that provide guidance on what is included in the cost of an asset include: IAS 16 *Property, Plant and Equipment*, IAS 27 *Separate Financial Statements*, IAS 38 *Intangible Assets*, IAS 40 *Investment Property*, IAS 41 *Agriculture* and IFRS 6 *Exploration and for Evaluation of Mineral Resources*.

4.5 The IFRS Interpretations Committee findings also indicated that generally speaking while the basis of variability may differ across arrangements, payments dependent on future activity or use of the asset (such as sales, development milestones, etc.) were more common than those based on indexes or rates.

4.6 **Note to EFRAG TEG members – this section is still being developed and will be condensed to explain and contrast the existing IFRS requirements without the need to describe the requirements separately.**

IAS 2 Inventories

4.7 IAS 2 *Inventories* does not define cost, but notes that the purchase cost of inventories comprises 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.

4.8 Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

4.9 IAS 8 addresses the accounting for changes in accounting policies (for example when it is required by a new or a revised IFRS Standard, or a voluntary change), changes in accounting estimates (for example a change in the estimate of the useful life of an asset) and accounting errors.

4.10 Generally speaking, unless otherwise stated when adopting a new or revised IFRS Standard, an entity a change in accounting policy retrospectively, as if the accounting policy had always been applied. This is done by adjusting the opening balance the opening balances of affected component of equity for the earliest period presented.

4.11 On the other hand, changes in accounting estimates are accounted for prospectively. This is done by adjusting the relevant item (for example depreciation due to a change in the useful life of an asset) in the current period and future periods. Unlike a change in accounting policy, the past periods are not adjusted.

4.12 The guidance regarding the accounting for changes in estimates might be relevant when considering whether variable consideration leads to a change in the original cost price or whether it represents a subsequent change.

IAS 16 Property, Plant and Equipment

Cost - Initial recognition and measurement

4.13 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.

4.14 Cost includes all expenditure directly attributable to bring the asset to the location and condition necessary for its intended use. Borrowing costs that are directly attributable that are directly attributable to the acquisition, construction or production of a qualifying asset (as defined under IAS 23 *Borrowing Costs*) form part of the cost of that asset.

4.15 The cost of PPE includes the estimated cost of dismantling and removing the asset and restoring the site to the extent that such cost is recognised as a provision. Start-up costs and pre-operating expenses are not included in the cost of an item of PPE unless those costs are necessary to bring the asset to its working condition.

4.16 IAS 16 states that the cost of an item of PPE is recognised as an asset, if and only if:

a) It is probable that future economic benefits associated with the item will flow to the entity; and

b) The cost of the item can be measured reliably.

4.17 IAS 16 does not specifically address the initial recognition and measurement of variable consideration and whether that amount is included in the cost of a PPE.

Subsequent measurement under the cost model

4.18 IAS 16 requires that day-to-day repair and maintenance of maintaining and servicing PPE are recognised as expenses in profit or loss.

4.19 Costs incurred to acquire safety and environmental equipment may be recognised as part of the cost of a PPE cost. IAS 16 explains that although such costs are not directly increasing the economic benefits of any particular existing item of PPE, they may be necessary for an entity to obtain the economic benefits from its other assets. Such items of PPE qualify for recognition as assets because they enable an entity to derive economic benefits from related assets in excess of what could be derived had those items not been acquired. For example, a chemical manufacturer may install new chemical handling processes to comply with environmental requirements; without these new processes the entity is unable to manufacture and sell chemicals.

Subsequent measurement under the revaluation model

4.20 An entity may elect to measure a class of PPE at fair value, if fair value can be measured reliably. If this accounting is selected, then revaluations should be kept up to date, such that the carrying amount of an asset at the reporting date does not differ materially from its fair value. Any surplus arising on the revaluation is recognised in OCI except to the extent that the surplus reverses a previous revaluation deficit on the same asset recognised in profit or loss, in which case the credit to the extent of the surplus is recognised in profit or loss.

IAS 27 Separate Financial Statements

4.21 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 38 Intangible Assets

Cost - Initial recognition and measurement

4.22 Similar to IAS 16, an intangible asset is initially measured at cost. 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.

4.23 Similar to IAS 16, an intangible asset is recognised as an asset, if and only if:

a) It is probable that future economic benefits associated with the item will flow to the entity; and

b) The cost of the item can be measured reliably.

4.24 IAS 38 provides specific guidance on the accounting for research and development. Generally speaking development costs that meet specific criteria are capitalised and included in the cost of the intangible asset being developed. Research costs are expensed as they are incurred.

4.25 The Interpretation SIC-32 provides specific guidance for the accounting of website development costs. It informs that costs associated with websites developed for advertising or promotional purposes are expensed in profit or loss as they are incurred. Pre-development website costs are also expensed. Expenditure associated with the development of websites can be capitalised as part of cost of the intangible asset if they meet the criteria for development costs.

4.26 IAS 38 provides guidance on specific expenditure such as REACH costs (Registration, Evaluation and Authorisation of Chemicals in the European Union) . Furthermore, the requirements of IAS 38 apply to service concession arrangements under IFRIC 12 that are recognised under the intangible asset model.

4.27 Similar to IAS 16, IAS 38 does not address the initial recognition and measurement of variable consideration and whether that amount is included in the cost of an intangible asset.

Subsequent measurement under the cost model

4.28 Subsequent expenditure incurred to enhance an intangible asset can only be added to its cost if it meets the definition of an intangible asset and the general recognition criteria for intangible assets. However, other than development costs that meet the required criteria, in practice other subsequent expenditure is generally expensed.

4.29 Unlike IAS 16, which permits revaluations of items of PPE of the class, an intangible asset cannot be revalued unless there is an active market (as defined under IFRS 13 *Fair Value Measurement*). IAS 38 also permits intangible assets with indefinite useful lives (which are not amortised) to be revalued. The Basis for Conclusions (BCZ44) notes that it is difficult to determine the fair value of an intangible asset, if no active market exists. This seems to be the main reason why intangibles assets, without an active market, cannot be revalued.

4.30 When an intangible asset is revalued, the revaluation is accounted for using one of the following methods:

a) Restatement approach – the gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset and the accumulated amortisation is adjusted accordingly

b) Elimination approach – the accumulated amortisation is eliminated against the gross carrying amount of the asset.

IAS 40 Investment Property

Cost - Initial recognition and measurement

4.31 Similar to IAS 16, an investment property is initially measured at cost. 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 IFRS Standards.

Subsequent measurement

4.32 Subsequent to initial recognition, an entity must chose an accounting policy to be applied consistency, either to:

a) Measure all investment property using the fair value model (subject to some exceptions); or

b) Measure all investment property using the cost model.

4.33 Regardless of the policy choice, IAS 40 seems to suggest a preference for measuring investment property at fair value noting that it is difficult to justify a voluntary change in accounting policy from the fair value model to the cost model.

IAS 41 Agriculture

4.34 IAS 41 requires a biological asset to be recognised when:

a) The entity controls the asset as a result of past events;

b) It is probable that future economic benefits associated with the asset will flow to the entity; and

c) The fair value of the asset can be measured reliably.

4.35 IAS 41 requires a biological asset to be measured on initial and at the end of each reporting period at its fair value less costs to sell. 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.

4.36 Like IAS 16 and IAS 38, IAS 41 does not does not address the initial recognition and measurement of variable consideration and whether that amount is included in the cost of a biological asset.

IFRS 6 Exploration for and Evaluation of Mineral Resources

4.37 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'.

Users' information needs

4.38 The existing inconsistencies in IFRS requirements have raised concerns by users of financial statements about the lack of comparability for transactions involving the acquisition of assets with similar economic characteristics. Some users also question whether recognising an expense in profit or loss for an amount paid as additional consideration, produces relevant information. Indeed, it seems logical to consider that if an additional payment for an item acquired meets the definition of an asset, it should be recognised as an asset.

4.39 **[This section will consider the guidance in the *Conceptual Framework* on user needs relating to recognition and measurement of the cost of an asset.]**

Accounting alternatives

4.40 Various options come to mind in relation to how to reflect variable consideration in the cost of the item purchased – both at initial recognition and in subsequent periods.

4.41 Consider the purchase of a coffee machine. The price (the cost) of the coffee machine could comprise a fixed amount and a variable amount. The variable amount will depend on future activity of the coffee machine (number of coffee servings). The following "cost" alternatives in relation to variable consideration can be observed:

a) Option 1: The estimated amount of variable consideration is **recognised as part of the cost of the coffee machine** (and recognised as a liability)

   *Under this option, the **measurement of the asset is based on the measurement of the liability**. The amount that is recognised as variable consideration, is also recognised as part of cost of the asset.*

b) Option 2: The estimated amount of variable consideration **is not recognised as part of the cost of the coffee machine** (but recognised as a liability for variable consideration). Any difference is recognised in profit or loss or OCI.

   *Under this option, the **measurement of the asset is independent of the measurement of the liability**.*

c) Option 3: The estimated amount of value contributed by the additional variable consideration is **recognised as part of the cost of the coffee machine** (but do not recognise a liability)**.** Any difference is recognised in profit or loss (or OCI).

*Under this option, the **measurement of the asset is independent of the measurement of the liability**. It could be that the variable consideration is not recognised as a liability because it does not meet the definition of a liability under the Conceptual Framework (discussed under issue two).*

d) Option 4: Estimate the amount of variable consideration and separately estimate the amount of asset value contributed by the variable payment – **recognise the additional asset value as part of the cost of the coffee machine (adjust the cost)** and recognise a liability for variable consideration (based on a selected measurement bases for the liability).

*Under this option, the **measurement of the asset is independent of the measurement of the liability**. The difference arising between the measurement of the liability and the asset value is recognised in profit or loss.*

e) Option 5: **account for variable consideration** only in the period the variable consideration becomes a known (not on initial acquisition of the asset).

4.42 **The above set of cost measurement options can be summarised as follows**:

	Cost of the asset	**Liability for variable consideration**	**PL/OCI**
Option 1- measurement of **asset** based on liability	✓	✓	✗
Option 2 – measurement of asset independent of liability (not based on liability)	✗	✓	✓ Expense
Option 3 – measurement of asset independent of liability (not based on liability)	✓	✗	✓ Gain
Option 4– measurement of asset independent of liability (not based on liability)	✓	✓	✓ (expense or gain)
Option 5 - measurement of asset independent of liability - **account when variable consideration is known**	**?**	✓ (when known)	**?**

4.43 Under current IFRS Standards it is not obvious which of the above options would apply when accounting for an asset that includes variable payments. **The answer might be simpler if one considers the cost of the asset only at initial recognition**.

a) In this case, the tendency might be to recognise the variable payment as a liability and as part of the cost of the asset (Option 1). This is consistent with some of the existing IFRS requirements.

b) Option 2 might seem less acceptable as it would mean recognising a loss in profit or loss on the acquisition of an asset (so-called day 1 loss).

c) Option 3 might seem even less attractive – if an liability for variable consideration is not recognised, it might seem inappropriate accounting (especially applying prudence as an accounting concept) to recognise a "day 1" gain in profit or loss. However, prudence alone should not be the reason for not recognising an asset.

d) Option 4 might seem an attractive solution as it requires an independent assessment of whether an asset exists. This option seems to conform to the concepts under the Conceptual Framework and is consistent with some of the existing IFRS requirements.

e) Option 5 might be contrary to at least some IFRS Standards in case one concludes that there is either a liability or an asset that needs to recognised or both.

4.44 The issue becomes more complex when considering whether cost should be adjusted to reflect changes in variable consideration. Several IFRS Standards currently require remeasurement of liabilities (financial and non-financial) to be recognised in profit or loss and not as adjustments to cost.

4.45 **[These alternatives, together with other suggestions recommended by EFRAG TEG during the course of the discussions, will the developed further in this section**.]

4.46 Furthermore, a set of principles or guidelines could be helpful to determine in which cases cost should be adjusted at initial recognition (and in subsequent periods).

Presentation and disclosure proposals

4.47 [To be completed].

CHAPTER 5: THE INCONSISTENT MEASUREMENT ISSUE

Description of issue

5.1 The fourth issue is the inconsistent measurement issue. **Current IFRS provide different accounting requirements for initial measurement of a liability (or an equity instrument) subject to variable consideration**. This could affect the initial measurement of the acquired asset.

5.2 For example:

a) Some IFRS Standards require that to the extent the related asset is measured based on the measurement of the liability (or equity instrument), the amount of variable consideration that is recognised as a liability, is also recognised as part of the cost of the asset. However the issue could be that IFRS Standards provide different measurement guidance for liabilities (and equity instruments) and consequently assets with similar economic transactions would also be measured differently - for example a liability is measured differently under IAS 37 and IFRS 9. This could mean that similar assets, or assets with similar economic characteristics, would be measured differently.

b) Other IFRS Standards require that to the extent the related item acquired (and recognised as an asset) is measured independently of the liability (or equity instrument), the difference between the measurement of the liability (or equity instrument) and the asset would be recognised in profit or loss. This accounting treatment could apply to initial and subsequent measurement, or apply only to subsequent measurement. Some might question whether it is appropriate to recognise an expense/income when an asset is acquired (initially or subsequently or both).

5.3 The *Conceptual Framework for Financial Reporting* provides guidance on a selection of measurement bases (such as historical cost, current value and fair value) and observes that an asset and a liability should be measured using the most useful measure under the circumstances. It observes that:

When selecting a measurement basis, it is important to consider the nature of the information that the measurement basis will produce in the statement of financial position and the statement(s) of financial performance.

5.4 However, the *Conceptual Framework for Financial Reporting* provides limited guidance on whether, and if so when, the measurement of an asset depends on the measurement of the related liability (or vice versa).

5.5 Although the Framework does not specifically discuss a hybrid measurement – something between historical cost and current cost – it does not specifically prohibit the use of a hybrid measurement basis (such as adjusted historical cost, which could include adjustments to the cost for variable consideration – both at initial recognition and in subsequent periods.

Applicable IFRS Standards and differences in the requirements

5.6 Several IFRS Standards provide guidance on the initial measurement of a liability. These, together with the reasons why different IFRS Standards require different measurement basis, are discussed in this section.

5.7 The initial measurement of a liability is relevant when determining whether or not the cost of a related asset acquired when the liability is initially recognised and measured should be based on the liability. If the initial cost of the asset is not based on the initial measurement of the liability, the resulting difference would need to be recognised in profit or loss (or OCI).

5.8 **Note to EFRAG TEG members – this section is under development and will be condensed to explain and contrast the existing IFRS requirements without the need to describe the requirements separately.**

IFRS 2 *Share-based Payments*

5.9 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.

5.10 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.

5.11 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.

5.12 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.

IFRS 3 *Business Combinations*

5.13 Under IFRS 3, contingent consideration are measured at fair value at the time of the business combination and considered as part of the cost of the acquisition when determining goodwill.

IFRS 9 *Financial Instruments*

5.14 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).

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

IFRS 15 *Revenue from Contracts with Customers*

5.16 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;

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

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

c) the contract has commercial substance; and

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

5.17 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 highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the variable situation is resolved.

5.18 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.

IFRS 16 *Leases*

5.19 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.

5.20 Under IFRS 16 a lease liability is measured at the present value of the lease payments that are not paid at that date. 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.

5.21 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*

5.22 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:

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

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

5.23 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.

5.24 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.

IAS 19 *Employee Benefits*

5.25 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**:**

c) 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;

a) as an expense, unless another IFRS requires or permits the inclusion of the benefits in the cost of an asset;

b) 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.

5.26 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:

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

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

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

5.27 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.

5.28 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.

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

5.29 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:

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

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

5.30 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.

5.31 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.

5.32 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.

Users' information needs

5.33 [This section will consider the guidance in the *Conceptual Framework* on 'measurement'].

Accounting alternatives

5.34 [To be completed].

Presentation and disclosure proposals

5.35 [To be completed].

CHAPTER 6: THE ASSET MEASUREMENT UPDATE ISSUE

Description of issue

6.1 The issue is how and whether **subsequent changes in the amount of variable consideration should be reflected in the measurement of the cost of the asset.** Subsequent to initial recognition, the amount of a variable consideration liability will generally change because of a number of reasons.

6.2 Some IFRS Standards (and IFRS Interpretations) provide some guidance on this issue. However, the guidance is generally limited and may not be intended to be applied by analogy for other areas. In this DP this issue is referred to as 'the asset measurement update issue'. Overall, IFRS generally requires the subsequent measurement of a liability to be accounted for in profit or loss.

6.3 As previous discussed in issue three (cost and recognition issue), the cost of an asset need not depend on the related liability.

Applicable IFRS Standards and differences in the requirements

6.4 A number of IFRS Standards provide guidance on the subsequent changes in the amount of a liability. In many cases, the general principle is to recognise the changes in a liability in profit or loss. However, this is not the case in all IFRS requirements.

6.5 The subsequent measurement of a liability (for variable consideration) is relevant when determining whether or not the cost of a related assets should also be adjusted. If the cost is not adjusted, the resulting difference would need to be recognised in profit or loss (or OCI).

6.6 [To be completed].

Users' information needs

6.7 [This section will consider the guidance in the *Conceptual Framework* on 'measurement'].

Accounting alternatives

6.8 [To be completed].

Presentation and disclosure proposals

6.9 [To be completed].

CHAPTER 7: THE VALUE CHANGE ISSUE

Description of issue

7.1 As mentioned above in Chapter 1 the value of a consideration to be transferred could change when there is a time lag between the agreement of what to transfer and the transfer. For example, if it is agreed to transfer one kilo of gold in 30 days (which following the definition of variable consideration applied in this discussion paper, is not considered to be variable consideration), the price of the gold would likely change during those 30 days. This chapter addresses how to account for these value changes which are not considered to be variable consideration. Changes in value resulting from the consideration being variable are considered in Chapter 6.

7.2 In some exchanges the transfer of the consideration takes place immediately after the exchange have been agreed. In those cases there is no subsequent change in the value of asset to be transferred (measured in the functional currency of the entity) between the agreement of the exchange and the execution. In other cases, however, there is a time lag between the agreement of what to transfer and the transfer. In this time window the value of what has to be transferred might change. It seems to be unclear how to account for value changes.

7.3 For example, there seems to be diverging views and diversity in practice on how to account for future payments that changes in value due to for example the variability of the exchange rates. The issue relates to whether these changes can be included in the carrying amount of the acquired asset.

7.4 Another issue is how it would be useful to present changes in the value of the consideration if the entity holds the asset it can use to settle the liability. For example, if the asset is measured at cost, but the liability is updated to reflect what it would cost to have a third party to settle it.

7.5 The change in value resulting from of a consideration being payable in a currency that is not the functional currency of the entity would be covered by IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

7.6 The obligation related to the transfer could be covered by:

a) IFRS 2 *Share-based Payment* (if entities' consideration is 'share-based');

b) IFRS 9 (if the obligation is a financial instrument (and the change in its value is not due to a change in the amount of items to be transferred));

c) IFRS 15 (if the obligation relates to providing a customer with goods or services and the contract is not onerous);

d) IAS 19 if the consideration is related to benefits received from employees; and

e) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (e.g. if an entity would have to transfer a non-financial asset).

7.7 If the entity is already holding the asset to be transferred, the derecognition of this asset would be covered by the relevant standard, for example, IFRS 9, IAS 16 *Property, Plant and Equipment*, IAS 2 *Inventories,* IAS 40 *Investment Property*, IAS 38 *Intangible assets.* These standards are also relevant in relation whether any changes in the value of the consideration to be paid should be reflected in the measurement of the asset.

7.8 For this issue, IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities would also be relevant (if an entity provides a fix service (no variability on what is provided) but the price an entity would have to pay changes).

Differences in guidance

7.9 The section distinguishes and assesses differences in guidance between the following different issues mentioned above when describing the value change:

a) How the liability is measured.

b) Whether changes in value can be capitalised.

How the liability is measured

7.10 Most current IFRS Standards and IFRS Interpretations that address how the liability is measured when there is a value change do not provide a common guidance. The are some IFRS Standards where the liability is not updated for changes in value of what is provided and there are others where the liability (or equity) is updated.

7.11 Firstly, there are two IFRS Standards, IFRS 2 and IFRS 15 that would not result in an update of the liability (equity component) if this would be less/more expensive to fulfil. Under IFRS 15 the measurement of the liability (the performance obligation) would be based on the asset (cash) received. IFRS 15 would, however, only apply as long as the contract is not onerous.

7.12 Other Standards, for example IAS 21, IAS 37, IAS 19 and IFRS 9 would result in the measurement of the liability being updated if it would be more or less costly to settle it.

7.13 If the obligation is in a foreign currency, and the value change is caused by exchange rate differences, IAS 21 would be relevant.

7.14 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.

7.15 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.

7.16 If the liability would be covered by IAS 37, the measurement would be updated to reflect a current estimate of the expenditure to be incurred to settle the liability. Changes should be reported in profit or loss IAS 37 specifies that the best estimate of the expenditure required to settle the present obligation (that is the liability) is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. Therefore, it seems that if an entity have already the asset to use to settle the obligation, then an entity cannot measure the liability based on what the entity once paid for that asset.

7.17 In addition, according with IFRS 9, after initial recognition, an entity shall measure a financial liability at amortised cost unless the fair value option is applied. The fair value option can be elected at initial recognition if doing so eliminates or significantly reduces an accounting mismatch. Changes in fair value attributable to changes in credit risk of the liability designated are presented in OCI.

7.18 Finally, according with IAS 19, the measurement of the liabilities under IAS 19 is updated to reflect the circumstances on the reporting date.

Whether changes in value can be capitalised

7.19 As indicated, if the entity is already holding the asset to be transferred, there would be another issue related to whether changes in the value of the asset to be received should be reflected in the measurement of the asset.

7.20 [Currently, it is expected that this subsection will assess the difference in guidance on whether changes in the value of the asset to be received should be reflected in the measurement of the asset]

Users' information needs

7.21 [This section will consider the guidance in the *Conceptual Framework for Financial Reporting* on 'measurement'].

Accounting alternatives

7.22 [Currently, it is expected that this section will explore accounting alternatives for these two issues:

a) whether value changes in the consideration (that is not variable consideration) should be reflected in the measurement of the received asset (if this is measured at cost)

b) whether different guidance is needed for the situations under which the entity holds the asset it is going to transfer (for example there could be a situation where if the liability would fall under IAS 37 and the asset under IAS 16, an entity would recognise increases/decreases in the obligation in profit and loss but not the change in the value of the asset, but then when the entity settle the liability, the entity would recognise the difference between the carrying amount of the liability and the carrying amount of the asset in profit and loss.)]

Presentation and disclosure proposals

7.23 [Currently it is expected that the section will include some proposals on how the linkage between the assets and liabilities can be disclosed, when this would be relevant, and the linkage is not (sufficiently) reflected by means of the selected recognition and measurement requirements.]

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