EFRAG
European Financial Reporting Advisory Group

**EFRAG TEG meeting**
**3 – 4 March 2021**
**Paper 04-01**
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This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

# Supportable approaches to account for variable consideration Issues Paper

## Objective

1 The objective of this session is to present to EFRAG TEG several alternative approaches to accounting for variable consideration. As suggested by EFRAG TEG in past discussions the starting point for each of the approaches has been the liability for variable consideration. For each approach, the EFRAG Secretariat has considered a combination of recognition and measurement requirements for the liability for variable consideration as well possible outcomes for the accounting for the acquired good or service.

2 EFRAG TEG is asked to consider (and consult within their organisations on) the list of alternatives in paragraph 20 in order to:

(a) Eliminate those alternatives that do not warrant further development; and

(b) Identify any additional alternatives that could receive some support (not that they will be considered by the majority of constituents, but at least receive some support).

EFRAG TEG members are asked to provide their comments before 19 March 2021. Feedback will be presented for discussion at the 8 April 2021 meeting of EFRAG TEG.

## Objective and scope of the project

3 EFRAG is developing a discussion paper on the accounting for variable consideration. The paper considers situations where an entity is acquiring a good or service, and the amount of consideration (or part of) an entity will pay for the goods or services depends on one or several factors for which the outcome is not known at the time the good or service is acquired. The factors can both be within or outside the control of the entity that is acquiring the goods or services.


4 Variable consideration could also exist in the case where the consideration is determined before the acquired goods or services are transferred. This could, for example, be the case if a party has ordered 100 doses of a particular drug, and it has been agreed that the consideration will depend on how effective the drug is. The effectiveness of the drug is determined by a laboratory, and when that is determined, the consideration would be paid although the drug will be delivered at a future date.

5 EFRAG's discussion paper will consider:

(a) When a liability for variable consideration should be recognised;

(c) How the liability for variable consideration should be measured;

(d) How the amount for variable consideration should be reflected in the initial and subsequent measurement of the goods or services acquired.

6 In addition, the paper will include a section on how to account for value changes in the consideration to be transferred. This section is included because some contracts can be constructed in a manner that would either result in the consideration being considered variable or not – although the economic impact would be the same.

7 Variable consideration arising in business combinations is outside the scope of the discussion paper. The reason is that there would be special issues related to allocating any changes in the consideration for the business to the various assets of that business.

8 Furthermore, the discussion paper will not consider what goods or services are being exchanged in a contract involving variable consideration. For example, if an entity is acquiring 'something' involving a machine and the consideration depends (fully) on the number of widgets the entity is producing using the machine, a question could arise about whether the entity is buying the machine or has just agreed to pay a given amount for each widget it is producing using a machine made available by the "seller". Such issues were considered in a draft discussion paper developed by the UK FRC that EFRAG TEG has previously discussed.

9 In the discussion paper EFRAG is developing, it is assumed that it is known what is acquired. Accordingly, if the consideration an entity will pay for a machine (and nothing less, nothing more) depends on the number of widgets produced on the machine, the consideration is regarded as variable. If, on the other hand, an entity is paying e.g. EUR 2 for each widget it produces on a machine made available to the entity, the consideration for the production of each widget is not variable.

**Note to EFRAG TEG members**

10 Comments on how variable consideration arises (including practice examples and fact patterns) and the scope of the discussion paper are welcome, but they are not part of this consultation and will be considered at the next EFRAG TEG meeting where the project on variable consideration will be discussed in more detail.

## The issue

11 Although the discussion paper will consider separately the issues related to each of the topics mentioned in paragraph 5, it will also provide a number of possible alternatives for accounting for variable consideration that considers jointly the issues of paragraph 5. The EFRAG Secretariat considers that such an approach could be beneficial for the discussions with constituents when considering the discussion paper on how to account for variable consideration. Instead of referring to a long list of different parameters, constituents would be able to refer to a particular approach.

12 Many different alternatives could be created by combining the different options available for each of the subtopics of the topics listed in paragraph 5. However, some of these alternatives may have a higher likelihood of support than others. For example, during the most recent EFRAG TEG discussion of variable consideration, it was noted that alternatives would receive little support where the goods or services acquired (to the extent this would be measured at cost) would be measure on a different basis from the liability as this would result in a day one gain or loss.

13 The EFRAG Secretariat has accordingly tried to identify approaches, some of which might be currently applied in practice, which could receive support from some

constituents. The following paragraphs describe the approaches identified by the EFRAG Secretariat.

*Approaches identified by the EFRAG Secretariat*

14 The different approaches identified by the EFRAG Secretariat build on the approaches to account for variability used for accounting for liabilities under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases* and combines these with the different approaches EFRAG TEG has previously considered on how to reflect changes in variable consideration in the cost price of acquired goods or services.

15 The factors which distinguish these approaches are[1]:

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| Existence of a liability criterion (variability depends on future actions of the entity) | In order for a liability for variable consideration to be recognised, the definition of a liability should be met.<br><br>There are different views on whether an obligation exists if it depends on future activities of the entity (e.g., if the consideration depends on whether an entity uses an acquired good or not). Some consider that an obligation only exists if it does not depend on future actions of the entity. Others consider that an obligation also exists even if depends on future actions of the entity (see e.g., Basis for Conclusions accompanying IFRS 16, paragraphs BC163 – BC169). |
| Recognition threshold (probability of outflow) | Not all items that meet the definition of an asset or liability are recognised. Criteria can thus be introduced for when a liability for variable consideration should be recognised. Current standards include different guidance on this. In IAS 37, an obligation is only recognised if it is probable (i.e. more likely than not) that an outflow of resourced embodying economic benefits will be required to settle the obligation. IFRS 9 does not include such a threshold. |
| Measurement at:<br><br>- expected value; or<br><br>- best estimate (i.e., the most likely amount or expected value depending on which method the entity expects to better predict the amount of consideration it will have to transfer) | There are different approaches on how to address the variability in the liability arising from a variable consideration in the measurement. A weighted average probability based (or expected value) approach would probably be at least the starting point of fair value measurement under IFRS 9. In IFRS 15 variable consideration is, on the other hand, measured at the most likely amount or expected value depending on which method the entity expects to better predict the amount of consideration it will have to transfer. In the following this is referred to as 'best estimate'. |
| Updating measurement of the acquired goods or services when this is measured at cost | To the extent that the goods or services are recognised in the statement of financial position of the acquiring entity and are measured on a cost-basis, EFRAG TEG members have proposed the following treatments:<br><br>- The measurement should not be updated (as the concept of 'cost' does not allow for an update).<br><br>- The measurement should be updated to the extent the update in the liability reflects that more knowledge has arisen about the value of the good |

[1] In some cases, the table below refers to IFRS 9 and IAS 37, however, this does not mean that these are the only relevant IFRS Standards. The references have only been included to illustrate differences in current Standards.

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| | or service and hence the right cost price (i.e. an update should only be done to the extent the variability is related to the good or service or the performance of the good or service).<br>- The measurement should always be updated (it is a re-estimation of cost). |

16 The above factors are those the EFRAG Secretariat consider to be the most controversial when considering variable consideration. However, there are many other factors that could be considered. These factors are described and the reasons why they are not considered further are explained in the Appendix. The factors include:

(a) Whether an obligation to provide consideration if a future event occurs, meets the definition of a liability.

(b) Whether a liability for variable consideration should only be recognised to the extent it is highly probable that a significant reversal in the amount of the cumulative liability recognised would not occur.

(c) Whether or not to recognise liabilities for which the measurement is (very) unreliable.

(d) Whether the measurement of a liability for variable consideration should depend on the standard applying to the particular liability (instead of some general principles).

(e) Whether the initial measurement at cost of acquired goods or services should be independent on the measurement of the liability to transfer consideration.

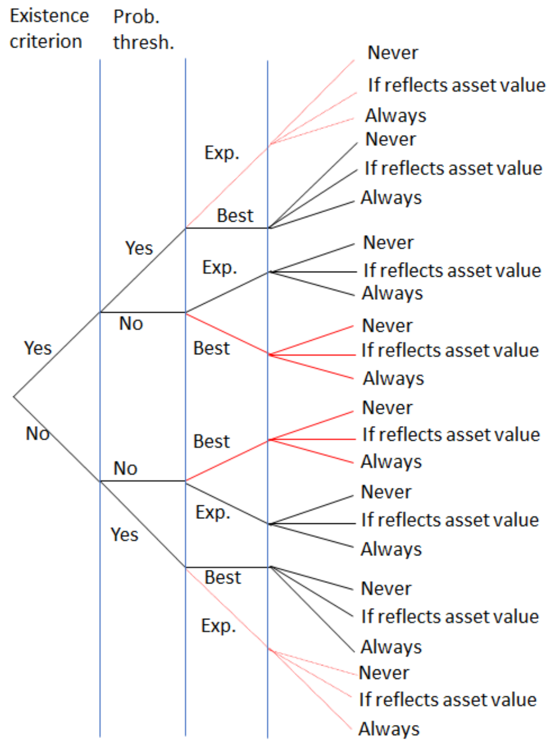
(f) Whether goods or services acquired that are not measured at cost initially or subsequently should also be updated to reflect the measurement of the liability to transfer variable consideration.

(g) Whether the measurement of acquired goods or services should only be updated for changes in the measurement of the liability to transfer variable consideration, that takes place within a given time period (e.g. one year).

17 Based on the four factors listed in paragraph 13, it is possible to make 24 different combinations. To reduce the number of options, the EFRAG Secretariat has tentatively assumed that those who would favour an approach under which a liability for variable consideration would always be measured at expected value, would not be in favour of a recognition threshold and that those in favour of a recognition threshold would rather favour a 'best estimate' measurement basis (rather than an expected value). Eliminating the options including measurement at fair value and a recognition threshold reduces the number of possible combinations to 12.

18 The elimination (the possibilities in red) is illustrated in the figure below.

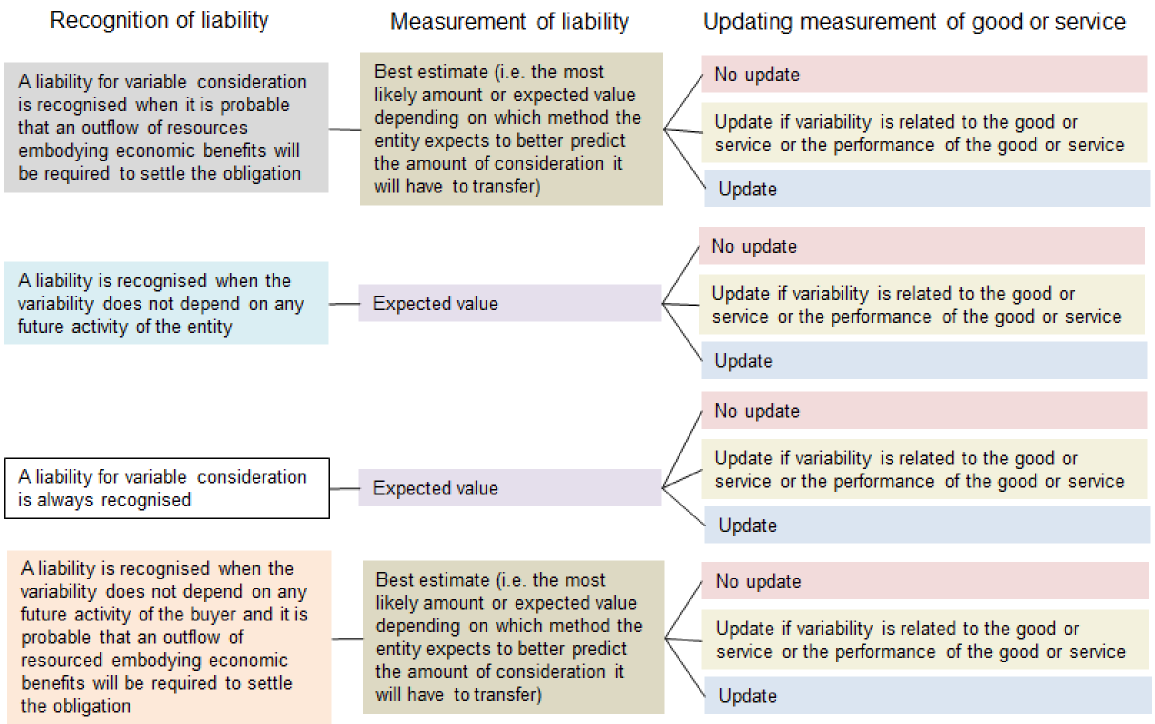
### Illustration of elimination of certain approaches




'Existence criterion' refers to whether a liability for variable consideration is only recognised if the variability does not depend on any future action of the buyer. 'Prob. thresh.' refers to whether a liability for variable consideration is only recognised if it probable that an outflow of resources embodying economic benefits will be required to settle the obligation. 'Meas.' refers to whether the variability is taken into account in the measurement of the liability using an 'expected value' or 'best estimate' approach. The last column considers the extent to which remeasurement of a liability to provide variable consideration should be reflected in the measurement of the acquired good or service (which would be measured at cost).

19 The 12 remaining approaches can be illustrated as follows (considering the different elements of the discussion paper (as summarised in paragraph 5 above):

### Illustration of 12 approaches to account for variable consideration



20 The approaches are summarised in the table below.

**Overview of 12 approaches to account for variable consideration**

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| Model 1 | A liability for variable consideration is recognised when it is probable that an outflow of resourced embodying economic benefits will be required to settle the obligation. | The variability will be measured at the 'best estimate' (i.e. the most likely amount or expected value depending on which method the entity expects to better predict the amount of consideration it will have to transfer). | Changes in the measurement of the liability will be recognised in profit or loss. |
| Model 2 | A liability for variable consideration is recognised when it is probable that an outflow of resourced embodying economic benefits will be required to settle the obligation. | The variability will be measured at the 'best estimate'. | Changes in the measurement of the liability will be reflected in the good or service acquired to the extent the variability relates to the acquired good or service. |
| Model 3 | A liability for variable consideration is recognised when it is probable that an outflow of resourced embodying economic benefits will be required to settle the obligation. | The variability will be measured at the 'best estimate'. | Changes in the measurement of the liability will be reflected in the good or service acquired. |
| Model 4 | A liability is recognised when the variability does not depend on any future activity of the buyer. | The variability will be measured at 'expected value'. | Changes in the measurement of the liability will be recognised in profit or loss. |
| Model 5 | A liability is recognised when the variability does not depend on any future activity of the buyer. | The variability will be measured at 'expected value'. | Changes in the measurement of the liability will be reflected in the good or service acquired to the extent the variability relates to the acquired good or service. |
| Model 6 | A liability is recognised when the variability does not depend on any future activity of the buyer. | The variability will be measured at 'expected value'. | Changes in the measurement of the liability will be reflected in the good or service acquired. |
| Model 7 | A liability for variable consideration is recognised. | The variability will be measured at 'expected value'. | Changes in the measurement of the liability will be recognised in profit or loss. |
| Model 8 | A liability for variable consideration is recognised. | The variability will be measured at 'expected value'. | Changes in the measurement of the liability will be reflected in the good or service acquired to the extent the variability relates to |

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| | | | the acquired good or service. |
| Model 9 | A liability for variable consideration is recognised. | The variability will be measured at 'expected value'. | Changes in the measurement of the liability will be reflected in the good or service acquired. |
| Model 10 | A liability is recognised when the variability does not depend on any future activity of the buyer and it is probable that an outflow of resourced embodying economic benefits will be required to settle the obligation. | The variability will be measured at the 'best estimate' (i.e. the most likely amount or expected value depending on which method the entity expects to better predict the amount of consideration it will have to transfer). | Changes in the measurement of the liability will be recognised in profit or loss. |
| Model 11 | A liability is recognised when the variability does not depend on any future activity of the buyer and it is probable that an outflow of resourced embodying economic benefits will be required to settle the obligation. | The variability will be measured at the 'best estimate'. | Changes in the measurement of the liability will be reflected in the good or service acquired to the extent the variability relates to the acquired good or service. |
| Model 12 | A liability is recognised when the variability does not depend on any future activity of the buyer and it is probable that an outflow of resourced embodying economic benefits will be required to settle the obligation. | The variability will be measured at the 'best estimate'. | Changes in the measurement of the liability will be reflected in the good or service acquired. |

**Questions for EFRAG TEG**

21 EFRAG TEG members are requested to provide written input before 19 March 2021 to:

rs@efrag.org and Isabel.batista@efrag.org on:

(a) Whether you consider that any of the approaches/models illustrated in paragraph 19 and summarised in paragraph 20 will not receive sufficient support from EFRAG's constituents?

(b) Are there other approaches/models you consider should be explored on the accounting for variable consideration other than those discussed in paragraph 19 and summarised in paragraph 20?

# Appendix

1 This Appendix lists examples of factors that are not considered in the model/approaches listed by the EFRAG Secretariat in paragraph 20 of Agenda Paper 04-01 (see paragraph 16 above).

2 These factors are described and the reasons why they are not considered further are explained in the following sections.

**Whether an obligation to provide consideration if a future event occurs, meets the definition of a liability**

3 In addition to considering whether a liability exists when the variability depends on future actions of the entity, it could be considered whether a liability exists when it is unknown whether an entity would have to transfer any consideration. That is, it could be questioned whether a liability exists today, if it would only be known in a future period whether consideration will have to be transferred. It might thus be argued that even in cases where the variability does not depend on future actions of the entity, a liability does not exist for variable consideration. In IFRS 16 *Leases*, only variable lease payments that depend on an index or rate should be included in the measurement of a lease liability. In that Standard, these lease payments are considered 'in-substance fixed lease payments'. From this one might conclude that all variable payments except for 'in-substance fixed payments' would not meet the definition of a liability. This would be the case even when the variability does not depend on future actions of the entity. However, the Basis for Conclusions accompanying IFRS 16 (paragraphs 163 – 169) indicates that this might not have been the view of the IASB when considering the definition of a liability in the leases project. The Basis for Conclusions of IFRS 16 explains that variability, in addition to the variability resulting from an index or market rate, could result from:

(a) the lessee's performance derived from the underlying asset; or

(b) the use of the underlying asset.

4 That is, the type of variability considered in IFRS 16 is limited to variability that depends on future actions of the entity. Variability that would not depend on future actions of the lessee (and would not be 'in-substance fixed') was not considered. Therefore, it cannot be deduced that variable lease payments that would not depend on future activities of the entity would not meet the definition of a liability.

5 Similarly, the argument for including variable lease payments that depend on an index or a rate in the measurement of lease liabilities was that: "Those payments meet the definition of liabilities for the lessee because they are unavoidable and *do not depend on any future activity of the lessee*" [emphasis added]. The Basis for Conclusions accompanying IFRS 16 does not seem to support the view that a liability would never exists for variable consideration (that is a liability that is not 'in-substance fixed' could exist).

6 Further, the Basis for Conclusions accompanying IFRS 16, notes that IASB members had differing views about whether variable payments linked to future performance or use of an underlying asset meet the definition of a liability.

**Whether a liability for variable consideration should only be recognised to the extent it is highly probable that a significant reversal in the amount of the cumulative liability recognised would not occur**

7 In addition to the 'more likely than not' recognition threshold, a recognition threshold mirroring the constraint used in IFRS 15 could have been considered. Under such a threshold, a liability for variable consideration should only be recognised to the extent it is highly probable that a significant reversal in the amount of the cumulative liability recognised would not occur when the situation causing the variability is

resolved. The EFRAG Secretariat, however, notes that the constraint of including in revenue only amounts that would not result in a significant reversal in a subsequent period was introduced following consultations with users and would mean that reported revenue (and profit) would not be optimistic (i.e., the constraint would result in financial statements being prudent). Including the same constraint for a liability would have the opposite effect – that is be imprudent (to the extent that the variable consideration is not reflected in the measurement of the acquired good or service). The alternative threshold has thus not been suggested by the EFRAG Secretariat as an approach that is likely to be supported by a significant number of constituents.

**Whether or not to recognise liabilities for which the measurement is (very) unreliable**

8 Although not mentioned explicitly, all the approaches suggested by the EFRAG Secretariat include a recognition threshold such that if the measurement of a liability were to be so unreliable that its recognition may be misleading, the liability should not be recognised. This reflects the position EFRAG has expressed in the past (see e.g., EFRAG's response to the IASB's Exposure Draft on the *Conceptual Framework for Financial Reporting*). EFRAG could have considered whether a recognition threshold related to reliability should *not* have been included. The EFRAG Secretariat is aware that some hold the view that not recognising a liability has the same effect as measuring the liability at zero. They consider this to be worse than measuring the liability at another amount which may be wrong. However, the latter view has not been expressed by many of EFRAG's constituents, and this view has accordingly not been reflected in any of the alternatives the EFRAG Secretariat expects could be supported.

**Whether the measurement of a liability for variable consideration should depend on the standard applying to the particular liability (instead of some general principles)**

9 Under the proposed alternatives, all recognised liabilities related to variable consideration would either be measured at the 'expected value' or 'best estimate' (i.e., the most likely amount or expected value depending on which method the entity expects to better predict the amount of consideration it will have to transfer). An alternative would be that some liabilities would be measured at 'expected value' and other liabilities would be measured at 'best estimate' (e.g., IAS 37 measurement approach for liabilities). However, such an approach would not remove one of the current perceived inconsistencies when accounting for variable consideration. The EFRAG Secretariat notes that 'expected value' is part of 'best estimate'. The EFRAG Secretariat would therefore suggest that instead of including an alternative that some liabilities for variable consideration should be measured at the 'expected value' while others should be measured at the 'best estimate', further principles on when to use 'expected value' under a 'best estimate' approach should be developed depending on the type of liability.

**Whether the initial measurement at cost of acquired goods or services should be independent on the measurement of the liability to transfer consideration**

10 In order to solve the current issue that the cost price of acquired goods or services would depend on which IFRS Standard is used to account for the consideration (e.g., IAS 37 or IFRS 9), one could consider that the measurement of the goods or services would be independent of the measurement of the liability. However, this would mean that a gain or a loss would be recorded when recognising the acquired goods or services. The EFRAG Secretariat has therefore not considered these cases in the approaches discussed in this paper.

**Whether goods or services acquired that are not measured at cost initially or subsequently should also be updated to reflect the measurement of the liability to transfer variable consideration**

11 Under the possible approaches suggested by the EFRAG Secretariat, the measurement of a liability for variable consideration would only be reflected in the measurement of a goods or services to the extent that theses goods or services are measured at cost initially and subsequently. This also means that in the case that a financial instrument is the 'good' or 'service' acquired for variable consideration the measurement of this financial instrument would be outside the scope of this discussion paper. As the EFRAG Secretariat assesses that EFRAG TEG would generally support not considering, for example, the subsequent measurement of some financial assets as part of this project, the EFRAG Secretariat has assessed that there would be very little support for broadening the scope of the project to also include acquired goods or services measured at fair value.

**Whether the measurement of acquired goods or services should only be updated for changes in the measurement of the liability to transfer variable consideration, that takes place within a given time period (e.g. one year)**

12 Other approaches on when the measurement of an acquired goods or services (measured on a cost basis) should be updated, could include an IFRS 3 approach under which the measurement should be updated for changes happening within a given time interval. Such an approach has not been included as the one-year time period included in IFRS 3 could relate to the issues with allocating changes to the various identified assets in a business combination.