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Paper 10-02
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Variable consideration
An approach where the purchaser may recognise an equity component before a liability is recognised

Objective and Introduction

1 The objective of this session is to discuss a possible interpretation of current requirements / an approach on when a purchaser should recognise a liability for variable consideration and to consider whether/how this should be included in the Discussion Paper.

2 Based on the discussions at the July 2021 EFRAG TEG meeting, it was suggested to consider an approach/interpretation of current guidance where the purchaser might recognise an equity component when it receives a good or service, and when the variable consideration is paid in a financial instrument and depends on the purchaser's future actions.

3 When presenting alternatives to account for variable consideration, the approach presented in this paper has not previously been presented by the EFRAG Secretariat.

Description of the approach

Example taken from July/September 2021 EFRAG TEG meeting – Initial example)

4 At the July/September 2021 EFRAG TEG meeting, the following example was presented:

Entity B has developed a recipe that will make chocolate paste preserve its consistency at higher temperatures. It has sold the intellectual rights of this recipe to Entity A (the contract is thus non-executory). Entity A could resell the recipe to anybody else, but as the recipe only works for the products that Entity A is producing, this scenario is considered unlikely. Entity A will have to pay Entity B a one-off amount of CU 10 000 if it starts using the recipe. Entity A considers it more likely than not that it will use the recipe and based on its initial estimations, it expects that using the recipe could increase revenue by CU 5 000 per year.

5 The discussion of the example focused on whether Entity A should recognise a liability when it would receive the recipe from Entity B. The view was, however, expressed by an EFRAG TEG member that Entity A should not recognise a liability, but an equity component.

6 In this example, the two parties would have signed a contract and the variable payment Entity A might have to pay to Entity B is a financial asset, in this example, cash. Therefore, it could be argued that the relevant IFRS Standards to consider in this case would be IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments*. As Entity A has received the recipe, the contract is non-executory. However, as the potential future payment of the variable consideration may be

considered to be within the control of the purchaser, paragraph 25 of IAS 32 could be read as stating that the possible future payment may not meet the definition of a financial liability. Paragraph 25 of IAS 32 states:

A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) **that are beyond the control of both the issuer and the holder of the instrument**, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:

(a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine;

(b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer; or

(c) the instrument has all the features and meets the conditions in paragraphs 16A and 16B.

[emphasis added]

7 If the possible future payment would not be a financial liability, it could thus be argued to be the residual – an equity component.

Initial recognition

8 This equity component may thus be computed as the present value of the future payment.

9 To the extent possible, the future payment may be presented as an equity component, for example, either in retained earnings or other equity, depending on, for example, local legislation.

Subsequent measurement

10 The measurement of the equity component would not be remeasured to reflect changes in the estimate that the entity would ultimately pay. If Entity A would decide not to use the recipe, the amount would therefore stay in equity.

11 If Entity A starts to use the recipe, then there would be a reclassification from an equity instrument to a financial liability. The initial measurement of the financial liability would be at fair value (which could be different from the initial/current measurement of the equity component).

Considering the unit of account if part of the consideration is fixed

12 At the July/September 2021 EFRAG TEG meeting, the following modification to the initial example was presented (Modification 2):

Entity A would have to pay a fixed consideration to receive the recipe. So, Entity A will have to pay Entity B CU 5 000 when it receives the recipe and an additional CU 10 000 if it starts using the recipe.

13 Based on the example in paragraph 12 above, the EFRAG TEG member indicated that one can question whether the additional payment of CU 10 000 is part of the same unit of account as the upfront payment of CU 5 000.

14 Those that consider these two payments as a single unit of account may argue that any payment is part of the same financial liability and the amount that the financial liability is measured at is a measurement question.

15 They could also argue that even if the two payments are under one single unit of account, the payment is a compound instrument because paying CU 5 000 is an obligation while paying CU 10 000 is fully within the scope of the entity buying the recipe.

16 Those that argue that these two payments are two separate units of account could argue that CU 5 000 is a financial liability and CU 5 000 is an equity instrument.

EFRAG Secretariat comments

17 As stated in Agenda Paper 10-03, when IFRIC discussed the issue, it noted that there were both arguments in favour and against recognising a financial liability for variable consideration that would depend on the purchaser's future actions. However, to the EFRAG Secretariat's knowledge, the IFRIC committee did not put forward that argument that an equity component existed and to the knowledge of the EFRAG Secretariat, in practice, no equity component is recognised for variable consideration that depends on the purchaser's future actions.

Should the approach be presented in the Discussion Paper?

18 The approach provided above is not the preferred one for the EFRAG TEG member who suggested this approach. However, to the extent EFRAG TEG considers that it represents a valid interpretation of current IFRS Standards, it could be mentioned in the Discussion Paper. The approach/interpretation could therefore shortly be mentioned as a possibility in the Discussion Paper without considering the approach in further detail.

Question for EFRAG TEG

19 Does EFRAG TEG consider that the approach described above should be mentioned in the Discussion Paper? If yes, do you consider that it should be mentioned that when payment of variable consideration is made in a financial instrument and the variability depends on the purchaser’s future actions, the current requirements could be interpreted as if an equity component should be recognised?