12 October 2023

EFRAG

Project Responsible

Mr. Vincent Papa

35 Square de Meeûs

1000 Brussels

Belgium

Dear Mr Papa,

RE: Submission in response to EFRAG's Discussion Paper: Accounting for Variable Consideration from the purchaser's perspective

In order to develop this comment letter the EAA's Financial Reporting Standards Committee appointed an author team to produce this academic input to the debate on accounting for variable consideration. Elisabetta Barone (Brunel University, London), Andrew Lennard (University of Glasgow), Stephani Mason (De Paul University, Chicago) and Luca Viarengo (Chair, Università Cattolica del Sacro Cuore, Milan) and the Financial Reporting Standards Committee (FRSC) of the European Accounting Association thank EFRAG for the opportunity to comment on its Discussion Paper: "Accounting for Variable Consideration from the purchaser's perspective". The purpose of the EAA's FRSC and the EAA members is to bring contributions of academic research to the standard-setting process related to Financial Reporting. In this comment letter, the authors aim to provide research-based input to the debate on accounting for variable consideration by addressing the questions raised by EFRAG in its Discussion Paper. A part of this academic input provided to the discussion on accounting for variable consideration was also presented at the 13th EAA – Reporting Standards Workshop on Accounting for Variable Consideration held in cooperation with EFRAG on the 5th of May 2023.

With this letter the authors, on behalf of the EAA's FRSC, provide points of attention to consider in relation to accounting for variable consideration. In addition the authors inform EFRAG and its project team working on accounting for variable consideration on additional references to relevant research in the area of accounting for variable consideration.

On the following pages we present our overview of the relevant academic literature. We would be pleased to answer any question you may have.

Yours Sincerely

Elisabetta Barone (Brunel University, London), Andrew Lennard (University of Glasgow), Stephani Mason (De Paul University, Chicago) and Luca Viarengo (Chair, Università Cattolica del Sacro Cuore, Milan) and the EAA's Financial Reporting Standards Committee

In the remaining part of this letter, the authors follow the structure and the questions included in EFRAG's Discussion Paper: Accounting for Variable Consideration from the Purchaser's Perspective.

General comments

0.1 As the Discussion Paper (DP) demonstrates, the subject of variable consideration gives rise to difficult issues that may be conducive to diversity in practice. Inappropriate accounting for variable consideration appears to have played a part in some conspicuous company failures. We are therefore pleased that EFRAG has undertaken work in this complex area. However, we are afraid that the approach taken in the DP might not be the most suitable to tackle the issue at hand.

0.2 First, the DP addresses only cases in which variable consideration arises that existing accounting standards do not presently address. A more conceptual approach would produce a more understandable and coherent set of solutions for the numerous issues that do and will arise.

0.3 One of the consequences of the exclusion from the scope of the DP of existing standards is that the scope of the DP itself is unclear and lacks a rationale despite the lengthy treatment of the topic given in Chapter 1. It is difficult to foresee how any conclusions based on the DP might fit with variable consideration that arises, for example, under a lease (which the DP excludes because IFRS 16 addresses it) or with variations that arise due to fluctuations in exchange rates.

0.4 This view is apparent in paragraph 1.13 of the DP. This section states that a contract to be settled in a fixed quantity of apples <u>is not</u> within the scope of the DP. However, a contract to be settled at a price varying with the price of apples <u>is</u> within the scope. What about a contract requiring a fixed quantity of a commodity generally priced in a currency other than the purchaser's functional currency? The point is not that the accounting for contracts that appear superficially similar should necessarily be the same, but rather that if there are differences, the reasons for them should be clear. A standard-by-standard approach not informed by a general framework incurs the risk of accounting arbitrage and opportunism. Wüstemann and Wüstemann (2010) argue this and claim that a consistent application of accounting standards can only be achieved if the accounting standards themselves are internally consistent, which in turn presupposes the existence of general guidance inspiring the standards.

0.5 The DP "only considers the situations where it has been determined that a purchaser has acquired one particular asset (i.e., the acquired asset does not include unrecognised additional rights) and the consideration for that particular asset is variable" (paragraph 1.35). This passage is problematic because different interpretations of a given transaction, e.g., one viewing it as a staggered acquisition and/or one as the acquisition of a unique good/right/service, could lead to the application of different standards. Moreover, examining a staggered acquisition of goods/services/rights as a whole could shed light on the substance of the transaction and inform the appropriate accounting of each individual acquisition composing the transaction. Moreover, the passage mentioned above assumes that it is clear what "the asset" is. The DP seems to assume that "the asset" is the underlying property (e.g., a machine, land, or broadcasting rights), but the views of reporting entities may differ.

0.6 An alternative view of a transaction that requires variable consideration is that the purchaser has acquired not one but two assets: a restricted right-of-use asset over the property (land or machinery, for example) and an option (or a commitment) to 'acquire more' of that property (or an additional asset or right) when the variable consideration payment is triggered. The alternative view would seem to align with the IASB's Conceptual Framework, which defines assets in terms of rights and liabilities in terms of obligations, and also with IFRS 16, which requires recognition of a right-of-use asset and not the whole property. Thus, we would expect any analysis of variable consideration to address whether such rights (and corresponding obligations) should always, sometimes, or never be reflected in financial statements.

0.7 A transaction with variable consideration will likely include a fixed and variable element. The DP assumes that accounting for the fixed element is unproblematic, but it should consider the transaction as a whole. For example, the case in which the fixed consideration is set to capture the expected value of the asset acquired and the variable part is aimed at capturing the unexpected component of its value might need to be treated differently than the case in which there is no fixed consideration and in which the variable consideration aims to capture the total value of the asset. For example, a seller might sell a mine (a) outright for a cash consideration of €1.1m; (b) for a fixed consideration of €1.0m + €0.2m if commercial quantities of mineral X were discovered; (c) for a variable consideration of €0.1m for each X quantities of mineral extracted. The different payment structures contain information on expectations and uncertainty regarding the value of the mine that could be useful to inform accounting choices.

0.8 The DP focuses on only one relatively simple example of the sale of chocolate spread. As a result, it is not always clear how any conclusions or principles might apply to transactions that are structured differently. Comparing a few examples might be helpful in discussing this point.

Example A (this is the illustrative example of point 2.7 – 2.8)
In exchange for fixed consideration, Entity A (purchaser) has acquired from Entity B (seller) the intellectual rights of a recipe that Entity B has developed. The recipe will make the chocolate spread preserve its consistency at higher temperatures. Entity A has no contractual restrictions from selling the recipe to other parties, but as the recipe only works for the products that Entity A is producing, it is unlikely to do so. Also, Entity A can keep the rights to the recipe. In addition to the fixed consideration, if Entity A will sell over 10 000 jars of chocolate spread over five years, then the consideration to be paid to Entity B is CU 1 per jar of chocolate spread sold above the first 10 000 jars sold, and the payment will be in cash. For example, if Entity A sells 50 000 jars over the next five years, it will have to pay Entity B CU 40 000.

Example B
Consider the same situation as in Example A. However, in addition to the fixed consideration, if Entity A sells over 10 000 jars of chocolate spread over five years, then the consideration to be paid to Entity B is CU 20.000 lump sum (i.e., even only one additional jar will trigger the additional payment).

Example C
Consider the same situation as in Example A. However, in addition to the fixed consideration, for each jar that Entity A will sell over five years, it will need to pay Entity B CU 1. For example, if Entity A sells 50 000 jars over the next five years, it will have to pay Entity B CU 50 000 (this example varies w.r.t. Example A because it considers no threshold for the variable payments).

Appropriate accounting for variable consideration might depend on the structure of the variable consideration itself. It would be easy to make the case that variable payment should be expensed in Example C, while it could be reasonable, under certain conditions, to recognise a liability and the corresponding asset considering Example B. Example A would lie between the other two. We will make use of these examples in our subsequent discussion.

0.9 For these reasons, a more conceptual approach should be adopted, starting with the IASB's Conceptual Framework for Financial Reporting issued in March 2018.

Reflection on variable consideration might suggest modifications to or amplifications of the Framework are necessary or desirable. The Framework should not be an unwelcome constraint but provide an obvious starting point. The objective should be to develop a coherent set of principles that can be consistently applied.

0.10 The previous point relates to recent research by Schipper (2022). The author claims that one of the reasons that some accounting issues have proven difficult to solve can be related to the fact that existing conceptual frameworks contain either no guidance or indeterminate guidance for resolving them. In particular, the author lists several sources of complexity that might make the solution to an accounting issue challenging to identify. We find it useful to present a few of them:

"a) Differing treatment of otherwise similar arrangements and items depending on the context in which the arrangement or item occurs. The differing treatment could be specified in either of two ways. First, standards may explicitly require accounting for similar arrangements and items differently depending on context, for example, variable consideration. Second, standards may require or permit similar items to be classified into categories that apply dissimilar accounting, for example, certain debt securities held as investments. That is, the accounting treatment of an item or arrangement is not comparable within or across standards that provide guidance to account for that item or arrangement.

b) Application of the standard requires so many subjective judgments and estimates that the resulting reported information is unlikely to be comparable and timely

c) Required or permitted use of a financial reporting treatment that either is not defined conceptually or that violates elements definitions"

The sources of complexity previously listed could be relevant to the topic covered in the DP. The previous paragraph of this letter hinted at the issues described at point (a). Note that Schipper (2022) explicitly mentions variable consideration as an example of the issue described at point (a). In the following exposition, we will show that points (b) and (c) could be material for variable consideration.

0.11 Hoogervorst (2022) agrees with Schipper (2022) but warns that it would be wrong to believe that conceptual clarity automatically leads to the best accounting solution. We agree on this: while we acknowledge that the framework could be improved to encompass adequate guidance for variable consideration, it is also important that individual accounting standards include specific provisions on this topic that give concrete form to the principles in the framework.

0.12 The difficulty in finding a consistent way to account for variable consideration and the lack of clear guidance in the framework on this topic could be related to the broader debate involving several scholars and professionals on the framework's structure. The framework assigns conceptual primacy to the definition of assets and liabilities. Thus, only items that meet the definition of either an asset or a liability should be reported. Income and expenses are only a by-product of the recognition and measurement of net assets in the balance sheet (e.g., Dichev, 2017; Barker and Penman, 2020). Several authors, however, believe that the relevance and usefulness of financial reporting information could be increased by also providing conceptual guidance for the income statement and making explicit reference to the matching principle (e.g., Dichev, 2017; Lev, 2018; Barker and Penman, 2020, Kim and Kim, 2021).

0.13 We note that the Basis for Conclusions to IASB's Conceptual Framework (paragraphs 4.93ff) states that the matching principle should, in most circumstances, support the same conclusions as the asset/ liability approach. However, we believe there could be benefits from looking at an issue from different perspectives. The matching principle could constitute a valuable perspective to tackle the issue of appropriate accounting for variable consideration. While we generally use the asset/liability approach in this response, we also sometimes appeal to the matching principle, which makes the rationale for our position more immediately clear.

0.14 The DP highlights that one of the things we do not know (or at least have a clear consensus on) is the meaning of 'cost.' Developing such a consensus seems necessary if a conceptual approach to variable consideration is to be pursued.

0.15 There is an obvious risk that if we draw bright lines around 'variable consideration,' it will provide an opportunity for those structuring transactions to choose whether a contemplated transaction is within or without the requirements that apply. Several academic papers showed that accounting standards could leave room for opportunistic behaviour on the side of preparers, which could reduce the relevance and usefulness of financial report information (Heflin, Kwon and Wild, 2002; Li and Sloan, 2017; Tutino and Pompili, 2018; Smieliauskas, Craig and Amernic, 2022). Therefore, an accounting standard on the subject should emphasise the importance of substance over form and, in particular, that any variability in consideration should be realistically possible.

0.16 The DP assumes that to define appropriate accounting for variable consideration, contributors should focus only on recognition and measurement requirements, assuming that appropriate accompanying disclosure would be provided. We believe it would be better to consider all these aspects together, particularly for the case at hand. If a decision not to recognise commitments for variable consideration in the financial statements is made, it would be useful to disclose in the notes their existence and information that will assist the user in assessing the amount, timing, and uncertainty of future cash flows.

Response to questions explicitly raised in the Discussion Paper

QUESTION 1 - WHEN TO RECOGNISE A LIABILITY FOR VARIABLE CONSIDERATION

Chapter 2 explores two alternatives for requirements on when to recognise a financial liability for variable consideration that depends on the purchaser's future actions under IAS 32/IFRS 9:

a) Alternative 1: Recognising a liability when the purchaser obtains control of the asset acquired unless the purchaser would have a practical ability to avoid taking the action that would trigger the variable consideration.

b) Alternative 2: Recognising a liability when the purchaser performs the actions that trigger the variable consideration.

1.1 The difference between the two alternatives pivots around the time uncertainty is resolved. Alternative 2 allows recognizing a liability when the uncertainty on the purchaser's action is resolved. In contrast, Alternative 1 would require recognition of a liability under the uncertainty of the action that the purchaser will take, with the sole exclusion of the case in which the purchaser has the practical ability to avoid action (in this case, there would be no difference with alternative 2).

1.2 In paragraph 2.16, the DP seems to favour alternative 1 because the purchaser's revenues, net income, or debt-to-equity ratio are beyond the purchaser's control (see IAS 32). This proposition is unconvincing. First, it is debatable that the purchaser's revenues are beyond its control. The passage cited in the DP might be suitable to define the rule for presenting financial instruments, but it might be less suited to inform variable payment accounting. In general, it is possible to claim that the purchaser's revenues are in its control: the purchaser might decide to shut down a product line, thus influencing its revenues. So if an asset could be used only for a particular product (as in the chocolate spread example) and variable payment depended on revenues or profits of that product, then the purchaser retains control of whether to continue or discontinue the product. It has no obligation for variable consideration, and recognizing a liability would not be appropriate.

1.3 It would also seem that alternative 1 would require the purchaser to estimate the total amount of consideration that will arise under the transaction. This requirement presumably would give rise to verifiability, subjectivity, and comparability issues. Indeed, including variable consideration in a contract suggests that the parties to the transaction themselves considered that agreeing on a fixed amount that reflects the total value of the asset and liability exchanged would be difficult and perhaps impossible. In contrast, under alternative 2, the purchaser presumably will know the economic consequences of triggering a payment for variable consideration, and hence, these can be quantified with reasonable certainty. For these reasons, alternative 2 should be preferred.

1.4 The previous paragraph resonates with a passage of the Conceptual Framework: "In some cases, the level of uncertainty involved in estimating a measure of an asset or liability may be so high that it may be questionable whether the estimate would provide a sufficiently faithful representation of that asset or liability" (Conceptual Framework, par. 5.20).

1.5 Verifiability, subjectivity, and comparability issues will affect both preparers and auditors. One might question how auditors can assess if the liability is correctly accounted for if the liability's value depends on the preparer's will.

1.6 We discuss the ambiguity about the asset that is recognised in par. 0.5-0.6. This is relevant to the question of when a liability is recognised, as, assuming an arms' length transaction, there must be a liability (or a reduction in an asset, probably cash) equivalent to the amount of the asset. Thus, those who believe that the asset is the whole item of property will tend to support Alternative 1, while those who favour the right-of-use view will probably support Alternative 2. Given that the DP does not discuss this issue, responses to this question should be treated cautiously.

The Chapter also includes assessments of qualitative characteristics of useful information for each of the two alternatives. Do you agree with these assessments?

1.7 We do not find the assessment of the qualitative characteristics helpful. It does not explicitly identify differences between the two alternatives considered, nor does it address the enhancing qualitative characteristics in the Conceptual Framework—comparability, timeliness, verifiability, and understandability. The DP also fails to consider that variable consideration could take different structures (consider examples A-C), and the assessment of qualitative characteristics of useful information could vary depending on the specific case considered.

1.8 The first point made under relevance (paragraph 2.52 a) (i)) invites contemplation of an example where the purchaser obtains an asset wholly for variable consideration and can use it to generate cash flows before the trigger for the payment of variable consideration occurs. The DP seems to accept the argument that not recognising a liability and hence no asset would not provide relevant information. However, the validity of this point is questionable. If an entity is able (and it is difficult to imagine when or why this should arise under market transactions) to obtain the right to use an asset without paying any consideration, treating the asset as having a cost of nil is both relevant and representationally faithful.

1.9 It is also lamentable to assume that superficially similar transactions should receive similar accounting, even where their substance may differ significantly. This premise seems to be underlying paragraph 2.52a)(ii). Paragraph 2.52a)(iii) addresses 'counterintuitive accounting outcomes.' This seems to be another way of referring to what one might perceive as a failure to secure a proper matching of income and expenses. While we agree that a failure to ensure proper matching may suggest a proposed principle is inappropriate, there should be recognition that there are many cases where there is no capitalisation for an accounting expenditure merely <u>expected</u> to produce economic benefits without conveying a <u>right</u> to such economic benefits.

1.10 When considering faithful representation, it should be remembered that in the Conceptual Framework, as revised in 2018, prudence was reintroduced as an aspect of neutrality (for a discussion of this topic, (see Pelger, 2020). Prudence "is the exercise of caution when making judgements under conditions of uncertainty. The exercise of prudence means that assets and income are not overstated, and liabilities and expenses are not understated." In the case of variable consideration, this would lead to contrasting conclusions. Prudence would favour the recognition of a liability for variable consideration but would suggest not recognizing the asset.

1.11 For the above reasons, we think qualitative characteristics should be reconsidered on a more conceptual basis, possibly explicitly considering the role of the matching principle in accounting for variable consideration.

Do you think that other alternatives for requirements for liabilities for variable consideration than those listed should be considered? If so, please specify these other alternatives.

1.12 The most obvious alternative approach would require recognising a liability for the expected value of total consideration (fixed and variable) for all cases. This option might be attractive to some as one could reason that the resulting asset would approximate the amount for which the asset could be purchased for a wholly fixed consideration. While we would not favour such an approach, a discussion of it would assist in understanding why the DP focuses on the approaches that it does.

When do you think a purchaser should recognise a financial liability covered by IFRS 9 for variable consideration that would depend on the purchaser's future actions? Please explain your answer.

1.13 We explained our views and the rationale underlying them above.

Are you aware of any issues relating to the measurement of a recognised financial liability for variable consideration? If so, please elaborate on these issues.

1.14 Practitioners will be able to provide more informed views on this point than we can. However, it would be reasonable to believe that the same issue affecting the accounting for variable consideration in business combinations may arise for variable consideration: creating a so-called "cookie jar reserve." Ferguson, Hu, and Lam (2021) explore the unintended consequences of valuing earnouts at fair value as required by IFRS 3 since 2008. The authors find that a significant portion of acquirers overstate initial earnout liabilities, with subsequent reversals recorded as operating income. Cross-sectional analysis shows that firms under-investment and performance-related pressure tend to overstate earnout liabilities, while high-quality auditors and debt-financed deals curtail managers' reporting discretion (see also Allee and Wangerin, 2018; Chaney, Gunn and Coleman, 2020).

1.15 The DP does not address the measurement of a recognised liability for variable consideration. It seems reasonable to assume that what is envisaged is that the liability would be discounted to present value at the reporting date and that it would be an expected value—that is, a value that reflects various reasonably likely outcomes, weighted according to their probability. This would seem to be consistent with current standards. However, consideration is warranted for the problem of objectively assessing the probabilities of various scenarios, including those that depend on the decisions and actions of the purchaser (the preparer of financial statements).

1.16 We cite Georgiou, Mantzari, and Mundy (2021) to substantiate the latter statement. They show that excess subjectivity in estimation could impair how decision-usefulness is perceived and experienced by financial analysts when using accounting estimates in their work. They claim that "what is more important for the analyst is to be provided with the least subjective, or more reliable, measure within the particular bounds of analysis." They also claim that "analysts like to have simplicity in accounting and how the use of different measurement methods is seen as going against this." Subjectivity is one of the points (point b, to be precise) that impair the useful application of accounting standards, as discussed by Schipper (2022).

QUESTION 2 - HOW TO ASSESS THAT AN ENTITY HAS NO PRACTICAL ABILITY TO AVOID TAKING AN ACTION

Chapter 2 suggests five alternative criteria for assessing when a purchaser would have no practical ability to avoid taking an action which would trigger a variable consideration (when the purchaser is not legally or constructively obliged to perform the future actions). The five suggested criteria are…

2.1 It is arguable that 'no practical ability to avoid' is reasonably clear without amplification. However, given the various circumstances that arise in practice, addressing the point with accounting standards or IASB guidance would be helpful. Our preference would be that this would be guidance rather than rigid prescriptions. The criteria suggested in the DP mainly complement each other and could inform professional judgement. The following comments consider each criterion individually as if each were the only consideration in a specific case.

a) When avoiding taking an action would mean that the purchaser would have to cease its activities.

2.2 This is unlikely to be an appropriate test. Of course, an entity is highly likely to take necessary action to enable it to continue its activities. However, the existence of a liability requires more than the mere likelihood of a future transfer of economic benefits. An entity may, for example, have to pay in the next accounting period for staff wages, electricity, or raw materials if it is to continue its activities. However, there is no liability at the reporting date in these cases.

b) When avoiding taking an action would have a significant unfavourable economic impact on the entity.

2.3 This is an appropriate criterion, though it would need to be accompanied by further guidance.

c) *When avoiding taking an action would have a significant unfavourable economic impact in the context of the acquired asset.*

2.4 This is vague. If criterion (b) were adopted, it would presumably include cases under (c).

d) *When avoiding taking an action would result in using an acquired asset in a manner that would not reflect the economic purpose of acquiring the asset.*

2.5 We doubt if this, taken alone, is an appropriate criterion. The purchaser has the practical ability to avoid taking the action that would trigger payment of the variable consideration. The DP presents the example of a football club that acquires a player with the expectation that s/he will play sufficient matches to trigger the payment of variable consideration. Assuming that the number of matches the player participates in is wholly under the club's control, the club could avoid paying the contingent payments by not fielding the player, and thus “using an acquired asset in a manner that would not reflect the economic purpose of acquiring the asset.”

2.6 It might have been expected at the acquisition of the asset when a fixed consideration was paid that variable consideration would be triggered and should be recognised as a liability and presumably included in the carrying amount of the asset to prove a complete depiction of the transaction. However, expectations sometimes change. If it turns out that the football player will not be fielded (for example, due to medical reasons or lack of performance), then either (i) if the variable consideration has not been recognised, the asset should be reviewed for impairment; or (ii) if the variable consideration has been recognised as a liability it would also be necessary to reduce the amount of that liability, with a corresponding profit. We would consider the result in (ii) anomalous.

e) *When avoiding taking an action would have marginal economically unfavourable consequences for the entity.*

2.7 This seems weak. It would also be costly to implement as it would require a purchaser to review all cases where avoiding action would be marginally unfavourable. Assessing 'marginal cost' requires distinguishing between fixed and variable costs, which is often difficult.

Do you agree that the above criteria are valid for assessing whether a purchaser would not have the practical ability to avoid performing a future action that would trigger variable consideration?

2.8 See our comments above.

QUESTION 3 - INTERPRETATIONS OF THE DEFINITION OF COST

Chapter 3 notes that the definition of 'cost' included in IAS 16, IAS 38, and IAS 40 ("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 Share-based Payment") is interpreted differently.

How do you interpret current requirements in relation to whether/when the measurement at the cost of an asset covered by IAS 16 or IAS 38 should be updated to reflect changes in estimates of variable consideration?

3.1 Practitioners will be able to provide more informed views on interpreting current requirements than we can. A more relevant question is whether changes in the amount of variable consideration should result in a different measurement of the related asset. We discuss this in the comments on Question 4 below.

How do you think 'cost' should be defined to provide the most useful information, and do you think it is useful to consider that measurement at cost should be similar across all IFRS Standards?

3.2 As mentioned above, the concept of cost requires consideration in its own right. A consensus on this would be relevant to many standards beyond variable consideration.

QUESTION 4 - POSSIBLE REQUIREMENTS FOR WHEN MEASUREMENT AT COST SHOULD BE UPDATED TO REFLECT CHANGES IN ESTIMATES OF VARIABLE CONSIDERATION

Chapter 3 explores the following three possible alternatives for requirements for when the cost of an asset should be updated in situations where the asset is acquired in exchange for variable consideration in cash or another financial instrument:

a) Alternative 1: Not updating the cost estimate.

b) Alternative 2: Updating the cost to reflect all subsequent changes in estimates of variable consideration.

c) Alternative 3: Sometimes updating the cost of an asset. The DP lists the following criteria, which could be used to determine when the cost of the asset should be updated. One or several of the criteria could be used:

- *Update if estimates of variable consideration are included in the measurement of the asset's cost at initial recognition.*
- *Update if the change in estimates of variable consideration takes place before the asset is ready for its intended use.*
- *Update the cost to the extent that variable payments are associated with future economic benefits to be derived from the asset.*
- *Update the cost to the extent that variable consideration is linked to the initial quality of the asset.*

Do you think that other possible requirements than those explored in the DP should be considered? If so, what are these other requirements?

4.1 No further requirements need to be considered.

Chapter 3 presents the qualitative characteristics of useful information for the three possible alternative requirements (including the four different criteria under Alternative 3) for when measurement at cost should be updated to reflect changes in estimates of variable consideration. Do you agree with the assessed characteristics of useful information for the alternatives? If not, which elements should be considered, and which assessments do you disagree with?

4.2 Table 3.3 mostly repeats the alternatives, adding comments on the cost to preparers. Therefore, the table does not help judge the merits of the various alternatives.

When do you think 'cost' should be updated to reflect changes in estimates of variable consideration? If you think that 'cost' should sometimes be updated, under what circumstances should it be updated?

4.3 As noted above, there is no clear consensus on the meaning of 'cost,' so any response to this question can be only tentative. Whether 'cost' should be updated inevitably depends on the particular circumstances and the decision to recognise the liability. If a liability is recognised only when the action is taken, it could be the case that there would be no need to update a cost (the value of the asset) that has never been recognised. There are cases (consider Example C) in which it would be sensible to expense the costs and not recognise any assets.

4.4 The case for updating seems strong when the event that gives rise to the remeasurement of the liability for variable consideration also evidences a change in the asset's value. For example, suppose the transaction is for an interest in land, and the contract provides that variable consideration will be payable if regulatory approval for redevelopment for a new use is granted. At the time of the transaction, whether regulatory approval will be granted is uncertain. Therefore, any liability regarding the variable consideration is recorded at a low amount (perhaps nil). If approval is granted, the liability should increase, and it would seem wrong not to recognise a corresponding increase in the 'cost' of the asset.

4.5 Table 3.1 notes the requirements of IFRS 16 about changes in residual value guarantees, which are required to be reported as changes in the carrying amount of the right-of-use asset. This requirement may lead to a perverse result. For example, if a liability for a residual guarantee is recognised initially at a low amount and it subsequently becomes generally known that assets of the kind in question are generally unsatisfactory (unreliable, unsafe, or whatever), the liability for the residual value guarantee would need to be increased. However, bad news about the asset should not lead to an increase in its carrying amount.

4.6 There will be other cases when a change in the amount of a liability for variable consideration results in an asset that is immediately consumed, as referred to in the IASB's Conceptual Framework (at paragraph 4.8). For example, in the chocolate spread example, each jar sold (over the threshold of 10,000 jars) incurs a liability to pay a variable consideration of CU 1. If this potential liability has not already been recognised, the additional cost should not be added to any previously recorded asset but treated as an expense (presumably within 'cost of sales') to provide an appropriate matching of income and expenses.

QUESTION 5 - GENERAL REQUIREMENTS ON ACCOUNTING FOR VARIABLE CONSIDERATION

Chapter 4 complements Chapters 2 and 3 of the DP by assessing the broader requirements for accounting for variable consideration. Chapter 4 examines the advantages and disadvantages of respectively developing a unified set of principles for IFRS requirements to account for variable consideration and undertaking Standard-by-Standard amendments that could apply to the two issues covered in Chapters 2 and 3 (i.e., liability recognition when payment depends on purchaser's future actions and measurement of the acquired asset).

Do you agree with the advantages and disadvantages identified?

Based on your assessment and the outlined advantages and disadvantages of respectively developing a unified set of principles for IFRS requirements to account for variable consideration and undertaking a Standard-by-Standard amendment, which of the standard-setting responses do you support?
Do you think that requirements to deal with the issues mentioned in Chapters 2 and 3 should be based on a unified set of principles for how to account for variable consideration?

5.1 The disadvantages of a piecemeal or standard-by-standard- approach have been identified above. In contrast, a set of principles for accounting for variable consideration would be valuable. Once agreed upon, those principles should be reflected in all IFRSs that deal with variable consideration. As suggested in the DP (at paragraph 4.71), this would not preclude the principles from being amplified or adapted depending on the specific kind of transaction under consideration. Nevertheless, existing standards should not be modified until agreement on the principles is achieved.

QUESTION 6 - APPLYING AN IFRS 15 MIRRORING APPROACH

Chapter 4 notes that requirements on variable consideration included in IFRS 15, could be 'mirrored' to provide guidance on how to account for a liability for variable consideration (with the exception of the constraint to only include in the transaction price the amount of variable consideration that is highly probable not to result in a significant reversal in the amount of cumulative revenue recognised).

Do you think such an approach would result in useful information? Please explain why or why not.

6.1 Not only is ‘Mirroring’ IFRS 15 discussed in Chapter 4, but it is also discussed in Chapter 3 (at paragraphs 3.53ff). Such an approach would not result in useful information as it would seem to require the recognition of items as liabilities that do not meet the definition of a liability, such as where a future outflow is probable, but the purchaser retains the practical ability to avoid it.

6.2 While it may be helpful to have regard to ‘mirroring’ IFRS 15 when developing an approach to variable consideration, it is unwise to assume that such a simple approach will be adequate.

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We would be happy to expand on any of the above comments if that would be helpful.

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This comment letter has been developed by a working group within the European Accounting Association, including Elisabetta Barone, Andrew Lennard, Stephani Mason, and Luca Viarengo (chair).

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