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Mr. Wolf Klinz
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16 January 2024

Dear Mr Klinz,

EFRAG Discussion Paper *Accounting for Variable Consideration from a Purchaser's Perspective*

The Australian Accounting Standards Board (AASB) Research Centre welcomes the opportunity to provide comments on the European Financial Reporting Advisory Group (EFRAG) Discussion Paper *Accounting for Variable Consideration from a Purchaser's Perspective*.

In our view, the Discussion Paper is an excellent contribution to current thinking on asset measurement and related liability measurement. Overall, we have two general comments on:

(a) initial asset measurement; and
(b) identifying principles that would apply only when the existing treatment is unclear versus principles that would potentially apply across all acquired assets measured at cost.

The detailed responses to the specific questions are in the Appendix to this letter. If you have any questions regarding this letter, don't hesitate to contact myself (kkendall@aasb.gov.au) or Eric Lee, Research Director (elee@aasb.gov.au).

Yours faithfully,

Keith Kendall

AASB Chair

Appendix A – AASB response to EFRAG Discussion Paper Accounting for Variable Consideration from a Purchaser's Perspective (September 2022)

The AASB Research Centre welcomes the opportunity to comment on the EFRAG Discussion Paper (DP) on Accounting for Variable Consideration from a Purchaser's Perspective. The below comments reflect the views of some AASB research staff.

We acknowledge the accounting treatment may vary depending on each fact and circumstance. To frame our comments, we use the illustrative example in paragraphs 2.7-2.8 (recipe example) as a helpful reference for our discussion.

The views provided below do not necessarily represent the views of the AASB members and staff. AASB Research Centre acknowledges that further research is warranted to understand the pervasiveness of the issue in Australia.

General Comments

In our view, the DP is an excellent contribution to current thinking on asset measurement and related liability measurement.

We have two general comments about the focus of the paper on:

1. initial asset measurement; and
2. identifying principles that would apply only when the existing treatment is unclear versus principles that would potentially apply across all acquired assets measured at cost.

Initial asset measurement

The DP provides a range of possible alternative accounting treatments of variable consideration from purchasers' perspectives. However, it may be helpful to start by focusing on the initial asset measurement issue for the following reasons:

- the motivation for the transaction that gives rise to the topic (as reflected in the recipe example) is the acquisition of an asset;
- the analysis of what has been acquired might help inform the outcome – in the recipe example, two distinguishable assets may have been acquired – see our comments on Question 3 below;
- a clear articulation of the basis of measuring assets at initial recognition seems to be a gap in IFRS Accounting Standards in respect of variable consideration;
- although the title of IFRIC 1 refers to 'Changes in … Liabilities', the issue arises from identifying an asset's cost under IAS 16 *Property, Plant and Equipment*.

This is not to suggest that the discussion should ignore the flow-on issues from an asset acquisition.

We also note from paragraphs ES16 to ES20 that the focus of the asset measurement discussion is on the cost model. However, we think that, in principle, the issues discussed in the DP can impact initial asset measurement at either cost or fair value, although the fair value context might lead to different conclusions. In particular, please see our comments on question 3 based on the AASB's thinking in respect of applying IFRS Accounting Standards in the not-for-profit sector.[1]

[1] Paragraph Aus15.1 of AASB 16 *Property, Plant and Equipment* states that "Notwithstanding paragraph 15, *not-for-profit* entities shall initially measure the cost of an item of property, plant and equipment at fair value in accordance with AASB 13 *Fair Value Measurement* where the consideration for the asset is significantly less than fair value principally to enable the entity to further its objectives. AASB 1058 *Income of Not-for-Profit Entities* address the recognition of related amounts."

Application of principles

The DP begins by focusing on obtaining an interpretation within existing IFRS Accounting Standards of how to address accounting for variable consideration from a purchaser's perspective.

However, by Chapter 4, paragraph 4.55, it is noted that the review of general IFRS requirements for variable consideration Appendix 2 has shown inconsistencies and absence of explicit requirements and that this finding supports the need for the development of a unified set of principles.

We agree that the aim of the project should also be to suggest reforms of some of the existing (settled) requirements if better accounting solutions are identified, and for the sake of conceptual consistency across different transaction types and Standards.

However, we are unsure about whether the paper seeks to address cases in which there is already a clear treatment set out in existing IFRS Accounting Standards (for example, lease right-of-use assets under IFRS 16 *Leases* and asset and liability impacts of changes in decommissioning restoration and similar liabilities under IFRIC 1). Generally, we think any further work following the paper should aim to identify a unified set of principles that would be potentially applicable across all topics where the cost or fair value measurement model is applied.

In our view, the fact that the IASB might not immediately apply the principles in reviewing existing requirements is not a reason to limit the potential scope of application of the research. We consider that it is useful to have research findings in place that can be used if and when new topics emerge, and existing requirements are reviewed and reconsidered.

[DP: 1.7 to 1.12]

We support using the term 'variable consideration' rather than 'contingent consideration' on the basis that it relates to a potentially broad set of circumstances, including when consideration might vary based on the extent to which something happens rather than whether or not something happens.

[DP: 1.23]

There is merit in starting by focusing on assets initially and subsequently measured at cost on the basis of avoiding complications with the fair value measurement model. However, we note that the same issues could apply in principle to assets measured at fair value – that is, whether fair value as at initial recognition is updated for changed estimates of, or actual, variable consideration or whether that is an issue associated purely with subsequent measurement.

In particular, we note that IFRS Accounting Standards routinely address measurement at initial recognition separately from subsequent measurement and, in a commercial setting, cost and fair value at initial recognition should be the same.

[DP: 1.24]

We note the paper acknowledges that IFRS 16 is clear about the accounting for variable consideration related to lease right-of-use assets and, therefore, such assets are not considered in the paper. While excluding lease right-of-use assets from the scope of the paper has helped focus the discussion on areas of contention, we note the following:

- The approach to lease right-of-use assets provides a possible precedent for responding to some of the questions posed in the paper – for example, that subsequent lease payment variations linked to an index or rate are recognised in both the lease liability and right-of-use asset cost base [IFRS 16.29, 30, 36(c) 42(b)]. In contrast, lease payment variations dependent on sales are not part of the lease liability or right-of-use asset cost [as illustrated in Example 14, IFRS 16 Illustrative Examples]. Whether that difference of treatment makes any sense outside a leasing situation would need to be considered.

- At some stage, there might be a case for changing IFRS 16 if the paper led to a unified set of principles which identified a better way to account for variable consideration related to lease right-of-use assets.

[DP: 1.31 to 134]

We note the paper acknowledges that IFRS 3 *Business Combinations* is clear about the accounting for contingent consideration in a business combination. The paper also acknowledges that the IFRS 3 approach is relevant to consider for the assets within the scope of the paper. Consistent with our comment on IFRS 16, at some stage, there might be a case for changing IFRS 3 if the paper led to a unified set of principles which identified a better way to account for contingent consideration in a business combination.

[DP: 1.35 to 1.40]

For the sake of simplicity and focusing on the key issues, we agree with the limitations of the paper outlined relating to the economic substance of transactions and risk sharing/collaborative arrangements.

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. (The Discussion Paper includes suggested criteria on when a purchaser entity would not have the practical ability to avoid taking the action(s) that would trigger the variable consideration (see Question 2 below).

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

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

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.

In our view, it is difficult to answer each question in isolation.

We think that, if the central issue is determining an asset's initial measurement, all the questions should be answered from that perspective – which would mean answering Question 3 first.

In responding to Question 3, we have indicated that the AASB's thinking in respect of applying IFRS Accounting Standards in the not-for-profit sector would tend to support measurement at initial recognition at fair value where the consideration for the asset is significantly less than fair value. The corollary of that approach is for any variable consideration liability to be recognised at the acquisition date at fair value – essentially Alternative 1.

QUESTION 1 – WHEN TO RECOGNISE A LIABILITY FOR VARIABLE CONSIDERATION (continued)

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.

If it is considered that any liability recognised at acquisition needs to fall within an existing IFRS Accounting Standard, the logical choices are either IFRS 9 *Financial Instruments* or IAS 37 *Provisions: Contingent Liabilities and Contingent Assets*. Facts and circumstances need to be considered to determine whether there is a financial liability (IFRS 9) or a provision (IAS 37) to be recognised.

There are seemingly two issues with the liability that need to be resolved that IFRS 9 or IAS 37 both address: [1] fair value measurement; and [2] whether subsequent re-measurement gives rise to expense/income or adjusts the asset.

In our view, the first issue can be addressed by reference to IFRS 13 *Fair Value Measurements* and the second issue should be addressed as an asset recognition and measurement issue and any liability accounting would follow.

Therefore, we would favour not addressing the liability issues by starting from either an IFRS 9 or an IAS 37 perspective.

QUESTION 1 – WHEN TO RECOGNISE A LIABILITY FOR VARIABLE CONSIDERATION (continued)

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.

No additional comment.

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:

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

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

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

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.

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

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?

The most recent IFRS Accounting Standard [IFRS 17 *Insurance Contracts*] uses 'practical ability' for determining insurance contract boundaries and presumably represents the IASB's most recent thinking. The contract boundary determines the extent of fulfilment cash flows included in measuring insurance liabilities and assets.

In an IFRS 17 context, 'practical ability' encompasses contract terms that have commercial substance – terms without commercial substance are disregarded [IFRS 17.9]. Applying that logic, an assessment would need to be made whether there is commercial substance to a purchaser's right to not perform future actions and thereby avoid the need to pay variable consideration, which essentially seems to be the thinking behind each of the five suggested criteria above.

The application of the notion of 'practical ability' in IFRS 17 has proved to be a matter of judgement.

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 cost of an asset covered by IAS 16 or IAS 38 should be updated to reflect changes in estimates of variable consideration?

We think a plain English reading is that the reference to "at the time of its acquisition or construction" applies to both the "cash or cash equivalents paid or the fair value of the other consideration". We interpret the reference to 'fair value of the other consideration" as the non-cash consideration transferred at the time of acquisition.

The AASB generally uses the IFRS Accounting Standards when setting reporting requirements for not-for-profit entities. Modifications are made only when considered necessary to achieve a useful outcome in not-for-profit circumstances.

It is common in the not-for-profit sector for assets to be acquired on favourable terms – either as gifts or at discounted prices. A literal application of the cost model in IFRS Accounting Standards would mean that assets could be measured at amounts that are greatly understated. Accordingly, when applying IAS 16 or IAS 38 *Intangible Assets*, Australian Accounting Standards require not-for-profit entities to initially measure assets at fair value in accordance with IFRS 13, where the consideration for the asset is significantly less than fair value principally to enable the entity to further its objectives.

Fair value is determined at the time of acquisition. If the cost model is adopted, that fair value is not updated (unless subsequently information/events reveal an error was made in determining the fair value at acquisition, in the context of IAS 8.41-48).

The corollary of this approach is for any liability associated with variable consideration to be recognised at its acquisition date at fair value.

Consistent with this approach, in the context of variable consideration, we favour the reference to fair value as applying at the acquisition date for any agreement to subsequently provide further consideration. In our view, the reference to "fair value of the other consideration" was included in the 'cost' definition to help ensure cost is a faithful representation at the time of acquisition.

In the recipe example, if the 'fixed consideration' mentioned in paragraphs 2.7 and 2.8 was a nominal sum on the expectation that the variable consideration would be within a particular range,

confining cost to the nominal sum could be misleading. A faithful representation would require the fair value of the variable consideration at the acquisition date to be included in 'cost'.

We considered whether the principles in IAS 10 related to 'adjusting' and 'non-adjusting' events provide any helpful insights. We concluded they tend to support not adjusting an asset's initial measurement because the information about variable consideration that is likely to change the view on fair value would relate to conditions arising after that date. However, we note that the IAS 10 requirements are designed for application to a specific period between reporting date and time of completion, rather than as a feature of 'business as usual' accounting.

QUESTION 3 – INTERPRETATIONS OF THE DEFINITION OF COST (continued)

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?

In principle, we think that 'cost' is determined at the initial recognition of an asset and that cost should include all relevant consideration, including estimated amounts that reflect the expected eventual transaction price.

While it might be more useful to have the cost updated if there is subsequently more relevant information available about the actual cost, we consider this would go beyond the conventional cost measurement model and into the realm of revaluation. Please note that this does not necessarily mean we favour cost measurement.

As a starting proposition, it would always be preferable for the same principles to apply across all IFRS Accounting Standards for initial asset measurement, unless there is a sound reason for there to be differences. We regard that as a premise underpinning the use of, and need for, a Conceptual Framework. Applying a mix of approaches to initial asset measurement is a potential source of confusion for users.

More than one asset being acquired?

In some circumstances, there is a possibility that more than one asset may be acquired.

In the recipe example, it may be reasonable to adopt the view that two assets are acquired:

- Asset 1: a right to use the recipe in making and selling 10,000 jars of chocolate spread over five years; and
- Asset 2: an option to acquire, at a pre-determined rate, a further right to use the recipe in making and selling more than 10,000 jars of chocolate spread over five years.

In theory, the consideration determined at initial measurement could be allocated to each asset, for example:

- Asset 1: the fixed consideration; and
- Asset 2: the variable consideration.

Alternatively, the cost may be allocated differently depending on the facts.

In our view, if there is more than one asset acquired, it would tend to imply that an estimate of the variable consideration should be recognised at the time of acquisition for the second asset and its related liability.

It might be useful to explore other examples, such as the acquisition of land that is currently zoned for farming, and additional/variable considerations that will be payable if the land is re-zoned to commercial/residential within two years. In this case, the transaction involves acquiring only one asset, but the promise of further consideration, if there is a re-zoning, is effectively an inducement

for the vendor to sell and, therefore, a part of the asset acquisition price for the purchaser. In keeping with our views above, we would regard the fair value of that inducement at the acquisition date as part of the asset's initial measurement.

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 Discussion Paper 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 Discussion Paper should be considered? If so, what are these other requirements?

In our view, the three alternatives are the relevant possible requirements.

While Alternative 3 was being contemplated, we noted that:

- The second suggested criterion (the second dot point) is relevant to the timing of commencement of depreciation/amortisation because of the link to consumption once an asset is ready for use, but in concept, it has no necessary association with the acquisition cost.
- The third suggested criterion is likely to be automatically addressed as a matter of possible impairment and there is no need for it to be used in determining the acquisition cost. That is, in principle, the acquisition cost should be determined independently of the expected future economic benefits and written down when there is an impairment.
- The fourth suggested criterion is similar to the third dot point and any deficiency in the 'quality' of the asset would be addressed as an impairment issue.

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

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?

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?

In general, the analysis of the Alternatives using the qualitative characteristics in Chapter 3 is sound.

We note that our view is first to address the issues related to the initial measurement of an asset.

In terms of the cost model, the asset measurement would not be subsequently adjusted for updated information about the actual variable consideration.

In terms of a fair value, or 'current value', model, the initial measurement is also not updated, but that subsequent measurements are adjusted for new information, which would include updated information about the actual variable consideration.

QUESTION 5 – GENERAL REQUIREMENTS ON ACCOUNTING FOR VARIABLE CONSIDERATION

Chapter 4 complements Chapters 2 and 3 of the Discussion Paper 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?

We agree with the advantages and disadvantages identified; however, we consider that some of the noted disadvantages are not necessarily inconsistent with taking a principled approach. Identifying the principles could be an exercise in itself and the outcomes deployed as and when post-implementation reviews or revisions of the relevant Standards are undertaken. Whether those reviews or revisions ultimately result in complete consistency is a different matter. In our view, the

principles could provide rigour to the review or revision process even if they are not necessarily implemented in all cases.

QUESTION 5 – GENERAL REQUIREMENTS ON ACCOUNTING FOR VARIABLE CONSIDERATION (continued)

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?

We agree with the arguments for developing a unified set of principles identified in paragraphs 4.67 to 4.71.

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?

In general, we support considering the 'IFRS 15 mirroring approach' as a possible way forward. However, while estimating the transaction amount at the acquisition date for variable consideration seems consistent with determining an initial asset measurement, subsequently updating the transaction amount does not.

We are in favour of exploring ways to improve the accounting for assets – however, if that is the direction the project takes, we think it is important to acknowledge that, when relevant, we may be going beyond the conventional cost measurement model.

Requirements are appropriately set out.