STAFF PAPER

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Project	**IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets***
Paper topic	Variable payments for the separate acquisition of property, plant and equipment and intangible assets

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Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a request to address an issue that is related to the accounting for variable payments for the separate acquisition of property, plant and equipment and intangible assets outside of a business combination.

2. The purchase price of an item of property, plant and equipment or an intangible asset may comprise fixed or variable payments, or both. For the purposes of this paper, variable payments are contractual payments for an item of property, plant and equipment or an intangible asset that vary if facts or circumstances change after the acquisition date. Examples of such variable payments include:

   (a) **Variable payments that are dependent on an index or a rate (such as LIBOR, inflation or the consumer price index)**. These variable payments are common in licence agreements or service concession arrangements. For example, an operator in a service concession arrangement agrees to pay an annual concession fee to the grantor, with the amount increasing at the end of each year based on the consumer price index.

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

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

3. The issues that the Interpretations Committee discussed are the following:

(a) When should the liability to make variable payments be initially recognised? Should the liability be systematically recognised as soon as the purchaser has agreed to make those variable payments (provided that the asset has been received by the purchaser)? In particular, for variable payments that are dependent on the purchaser's future activity, should the liability be recognised only when the activity requiring the payment is performed?

(b) Once the liability is recognised, should the subsequent adjustment of the liability resulting from the revision of the estimates of payments (if any) be systematically recognised in profit or loss (as IAS 39 seems to suggest)? Or should this adjustment be (at least partially) capitalised as part of the cost of the corresponding tangible/intangible asset purchased in certain circumstances?

4. At its November 2012 meeting, the Interpretations Committee discussed the **initial accounting** for variable payments. It observed that there are currently two diverging interpretations of the current requirements in IAS 32 *Financial Instruments: Presentation,* IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* regarding the timing of recognition of the liability to make variable payments for the separate acquisition of a tangible/intangible asset:

   (a) Alternative 1: all variable payments meet the initial recognition criteria of a financial liability on the date of purchase of the asset (provided that the asset has been received);

   (b) Alternative 2: variable payments that are dependent on the purchaser's future activity do not meet the initial recognition criteria of a financial liability until the activity requiring the payment is performed.

5. The Interpretations Committee could not reach a consensus on whether the variable payments that are dependent on the purchaser's future activity should be excluded from the initial measurement of the liability until that activity is performed. In all other cases (ie where the variable payments are not dependent on the purchaser's future activity), it tentatively agreed that the fair value of those variable payments should be included in the initial measurement of the liability on the date of purchase of the asset in accordance with IAS 32/IAS 39/IFRS 9 (provided that the asset has been received).

6. At its January and March 2013 meetings, the Interpretations Committee continued its discussions about the **subsequent accounting** for a financial liability to make variable payments. It decided to recommend to the IASB that it should amend IAS 16, IAS 38 and IAS 39 *Financial Instruments: Recognition and Measurement* to require that the subsequent adjustment of the carrying amount of a financial liability, which is not a floating rate instrument, is recognised as a corresponding adjustment to the cost of the corresponding asset in certain circumstances. A summary of the Interpretations Committee's discussions and tentative decisions is shown below.

Objective of the paper

7. The Interpretations Committee decided to recommend to the IASB to propose amendments to current IFRSs regarding the subsequent accounting for variable payments (although it did not reach a consensus on the initial accounting). Consequently, the objective of this paper is to summarise the Interpretations Committee's decisions regarding the subsequent accounting for variable payments and ask the IASB whether it agrees with the recommendation of the Interpretations Committee.

8. However, we think that initial accounting and subsequent accounting for variable payments are linked and should be addressed together. As a result, the objective of this paper is also to summarise the Interpretations Committee's discussions regarding the initial accounting for variable payments and ask the IASB:

   (a) whether it thinks that this is the right time to discuss the accounting for variable payments; and

   (b) if so, for its views on the initial accounting for variable payments.

Structure of the paper

9. The structure of the paper is as follows:

   (a) initial accounting for variable payments for the separate acquisition of assets;

   (b) subsequent accounting for variable payments for the separate acquisition of assets;

   (c) questions to the IASB and next steps; and

   (d) Appendix A: Simplified examples.

Initial accounting for variable payments

10. The Interpretations Committee could not reach a consensus on whether the variable payments that are dependent on the purchaser's future activity should be excluded from the initial measurement of the liability until that activity is

performed. In all other cases (ie where the variable payments are not dependent on the purchaser's future activity), it tentatively agreed that the fair value of those variable payments should be included in the initial measurement of the liability on the date of purchase of the asset in accordance with IAS 32/IAS 39/IFRS 9.

11. The objective of this section is:

    (a) to present the Interpretations Committee's discussions regarding the initial accounting for variable payments according to current IFRSs;

    (b) to present the different models that could be applied for the initial accounting for variable payments, including the Leases model and the IFRS 3 model; and

    (c) to present the staff analysis on the initial accounting for variable payments.

Initial accounting for variable payments according to current IFRSs

12. The Interpretations Committee observed that the obligation to pay a variable payment for the separate acquisition of an asset arises from a contract. As a result, such a variable payment should be accounted for in accordance with the requirements in IAS 32/IAS 39/IFRS 9.

13. When the contract establishes an obligation to pay a variable payment, IAS 32/IAS 39/IFRS 9 would lead to recognising a financial liability on the date of purchase of the asset for the fair value of the variable payment. Indeed, a financial liability is any liability that is a contractual **obligation** to deliver cash (or another financial asset) to another entity.

14. The definition of cost in IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* similarly requires that the cost of the asset on the date of purchase should include the amount of cash equivalents paid or the fair value of the other consideration given (such as an obligation to pay a variable payment).

15. As a result, the Interpretations Committee noted that the core issue regarding the initial accounting for variable payments is to decide whether the purchaser has an **obligation** on the date of purchase of the asset to pay the variable payment. This issue is a recognition issue. The Interpretations Committee observed that there are

currently two diverging interpretations of the current requirements in IAS 32/IAS 39/IFRS 9 regarding the timing of accounting for variable payments for the separate acquisition of tangible/intangible assets:

(a) Alternative 1: all variable payments meet the initial recognition criteria of a financial liability on the date of purchase of the asset;

(b) Alternative 2: variable payments that are dependent on the purchaser's future activity do not meet the initial recognition criteria of a financial liability until the activity requiring the payment is performed.

16. The Interpretations Committee could not reach a consensus on whether those variable payments that are dependent on the purchaser's future activity should be excluded from the initial measurement of the liability until that activity is performed. In all other cases (ie where the variable payments are not dependent on the purchaser's future activity), it tentatively agreed that the fair value of those variable payments should be included in the initial measurement of the liability on the date of purchase of the asset. The arguments used by the proponents of each alternative are shown below.

Alternative 1: all variable payments meet the initial recognition criteria of a financial liability on the date of purchase of the asset

17. Proponents of Alternative 1 think that all variable payments agreed in the purchase contract meet the initial recognition criteria of a financial liability and should therefore be initially included in the measurement of the liability to make payments for the separate purchase of an asset.

18. Proponents of Alternative 1 note that a contract to acquire a tangible/intangible asset is not executory if the corresponding tangible asset has been delivered to the purchaser or if the intangible asset (such as a licence to operate) has been granted to the purchaser. In that case, the seller has already performed its obligations. Proponents of Alternative 1 think that the purchaser's agreement to make the variable payments is the obligating event in a purchase transaction (provided that the asset has been received by the purchaser), even if the variable payments are dependent on the purchaser's future activity. They also note that IAS 39/IFRS 9 require financial liabilities to be measured at fair value on initial recognition (plus or minus transaction costs in certain cases) and think that excluding some variable

payments from the initial measurement of the financial liability is not consistent with a fair value measurement. A market participant would arguably consider those variable payments when estimating the fair value of the liability to make variable payments.

19. Proponents of Alternative 1 also point to IAS 32. IAS 32 (paragraph 19) specifies that if an entity does not have an unconditional right to avoid delivering cash (or another financial asset) to settle the contractual obligation, then the obligation meets the definition of a financial liability. IAS 32 (paragraph 25) goes on to say that a financial instrument that requires the entity to deliver cash (or another financial asset) 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 is a financial liability of the issuer. This is because the issuer of such an instrument does not have the unconditional right to avoid delivering cash (or another financial asset).

20. In other words, when dealing with variable payments for the separate purchase of an asset, if it is considered that the occurrence or non-occurrence of the future event that triggers the payment of the variable payment is under the control of the purchaser, then no liability should be recognised on the date of purchase of the asset. If it is considered that the occurrence or non-occurrence of the future event that triggers the payment of the variable payment is beyond the control of the purchaser, then a liability should be recognised for the fair value of the variable payment on the date of purchase of the asset.

21. The question that follows is to decide whether the occurrence or non-occurrence of an uncertain future event is beyond the control of the purchaser or not. IAS 32 (paragraph 25) specifies that 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 is beyond the control of both the issuer and the holder of the financial instrument. Proponents of Alternative 1 note that the issuer’s future revenues, net income or debt-to-equity ratio is considered to be beyond the control of the issuer according to IAS 32 and they think by analogy that the issuer’s future activity (or future performance) is also beyond the control of the issuer. As a result, variable payments that depend on an index or a rate or

that depend on the purchaser's future activity (such as revenues or profits) should be recognised as financial liabilities on the date of purchase of the asset.

Alternative 2: variable payments that are dependent on the purchaser's future activity do not meet the initial recognition criteria of a financial liability until the activity requiring the payment is performed

22. Proponents of Alternative 2 think that variable payments for the separate acquisition of a tangible/intangible asset that are dependent on the purchaser's future activity do not meet the initial recognition criteria of a financial liability until the activity requiring the payment is performed. They consider that those variable payments are avoidable and conclude that the acquirer does not have an obligation to make those payments.

23. Proponents of Alternative 2 also point to the guidance in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. According to paragraph 19 of IAS 37, it is only those obligations arising from past events that exist independently of the entity's future actions (ie the future conduct of its business) that are recognised as liabilities.

24. Proponents of Alternative 2 note that paragraph 25 of IAS 32 (see Alternative 1 above) was the result of the incorporation of SIC-5 *Classification of Financial Instruments—Contingent Settlement Provisions* into the revised version of IAS 32 (2003). SIC-5 stated that financial instruments such as shares or bonds for which the manner of settlement depends on the outcome of uncertain future events that are beyond the control of both the issuer and the holder are financial liabilities. SIC-5 did not address the accounting for financial liabilities that are related to the acquisition of a non-financial asset.

25. Lastly, proponents of Alternative 2 point to the guidance in IAS 39 regarding executory contracts (paragraphs 5, AG35 (b) and Guidance on implementing IAS 39, Section A *Scope*, paragraph A.1). Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement.

26. Proponents of Alternative 2 view variable payments that are linked to future activity as a means by which the purchaser and the seller can share risks and profits to be derived from the use of the asset after the asset has been received. In other words, they think that, through those variable payments, the purchaser and the seller agreed on a form of joint arrangement that is distinct from the initial purchase of the asset (and that should be accounted for separately from the initial purchase of the asset).

27. As a result, they think that liabilities to make those variable payments are not within the scope of IAS 39 until the activity requiring the payment is performed.

28. However, it should be noted that proponents of Alternative 1 do not think that variable payments for the separate purchase of an asset that depend on the purchaser's future activity are executory contracts:

   (a) if the corresponding PPE has been delivered to the purchaser; or

   (b) if the intangible asset (such as a licence to operate) has been granted to the purchaser on the date of purchase.

Initial accounting for variable payments in the Leases project

29. We note that the liability to make lease payments recognised by a lessee is a liability that gives rise to an asset (ie the right of use asset). This liability is accounted for in accordance with the requirements in IAS 17 *Leases* (and not IAS 39). The accounting for the liability to make lease payments and, in particular, the accounting for variable payments to make lease payments was discussed in detail by the boards in the *Leases* Exposure Draft (the ED).

30. It is worth noting the process that the boards went through in that project. The boards started with an approach that would have required an entity to estimate all variable lease payments and recognise this as a liability at lease commencement (these had been the proposals in the 2010 *Leases* ED). However, after considering the feedback received from respondents to the 2010 ED, the boards decided to follow a different model and to exclude, from the initial measurement of the asset and liability, variable payments other than payments that are in substance fixed payments (but structured as variable payments) and payments that are dependent on an index or a rate. As a result, variable lease payments that are dependent on

the lessee's future activity are excluded from the initial measurement of the liability (until the activity is performed).

31. However, we understand that the members of the two boards came to that conclusion for different reasons (see paragraphs BC148-BC155 of the ED Leases published in May 2013):

(a) Some board members are of the view that all variable lease payments meet the initial recognition criteria of a financial liability at lease commencement. However, they were persuaded by cost/benefit consideration not to insist upon this approach by the arguments made by respondents to the 2010 *Leases* exposure draft. Those respondents noted that to require the recognition of a liability at lease commencement for all variable payments would be extremely complex in many cases and would often not provide sufficiently useful information to users to outweigh the cost. This would be the case, in particular, when variable payments could not be reliably estimated (such as variable payments that are dependent on future sales or revenues over a longer lease term).

(b) Other board members are of the view that, when the event requiring the payment is dependent on the lessee's future activity, the liability should not be recognised until the activity is performed. This is because those payments are avoidable by the lessee and accordingly the lessee does not have a present obligation to make those payments. In addition, variable lease payments linked to future performance or use could be viewed as a means by which the lessee and lessor can share future profits to be derived from the use of the asset. Accordingly, those variable lease payments would not be included in the measurement of lease assets and lease liabilities.

32. In reaching these decisions, the volume of leases that many entities have (with some entities having thousands of leases), and the fact that variable payments are a relatively common feature within lease contracts, was an important consideration for the boards when assessing the costs and benefits of the measurement proposals.

33. As a result, if the principles in the Leases project were to be applied by analogy to the accounting for variable payments for the purchase of an asset, we think that:

(a) variable payments that are dependent on an index or a rate would be initially included in the measurement of the liability to make variable payments on the date of purchase of the asset (provided that the asset has been received); and

(b) variable payments that are dependent on the purchaser's activity would be initially excluded from the measurement of the liability to make variable payments until the activity is performed.

Initial accounting for contingent consideration in IFRS 3

34. Contingent consideration in a business combination is usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or specified conditions are met. According to IFRS 3 (paragraph 39):

(a) the consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement; and

(b) the acquirer shall recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

35. According to the Basis for Conclusions of IFRS 3 (BC346), the boards came to that conclusion for the following reasons:

(a) the acquirer's agreement to make contingent payments is the obligating event in a business combination transaction;

(b) the obligation to make future payments if the specified event occurs is unconditional (although the amount of the future payments the acquirer will make is conditional on future events);

(c) failure to recognise that obligation or right at the acquisition date would not faithfully represent the economic consideration exchanges at that date; and

(d) measuring the fair value of some contingent payments may be difficult, but to delay recognition of, or otherwise ignore, assets or liabilities that are difficult to measure would cause financial reporting to be incomplete and thus diminish its usefulness in making economic decisions.

36. As a result, if the requirements in IFRS 3 were to be applied by analogy to the accounting for variable payments for the separate purchase of an asset, we think that the fair value of all variable payments would be initially included in the measurement of the liability to make variable payments on the date of purchase of the asset.

Initial accounting for variable payments in the Conceptual Framework project

37. The IASB expects to publish the Conceptual Framework *Discussion paper* in July 2013. The IASB decided that the comment period for the Discussion Paper on *Conceptual Framework* should be 180 days. The IASB specifically discussed as part of the Conceptual Framework project whether a 'present' obligation exists if the eventual need to transfer economic resources depends on the entity's future actions. We understand that the IASB discussed three alternative views.

38. The IASB has tentatively rejected the view that an obligation must be strictly unconditional. It does not think that an entity should omit from its financial statements liabilities that have arisen from past events and that the entity has no practical ability to avoid. The IASB has not reached a preliminary view on whether the definition of a liability should include only those liabilities that the entity has no practical ability to avoid or whether it should also include conditional obligations that the entity might be able to avoid through its future actions but that have nevertheless arisen as a result of past events.

39. It should be noted that the identification of a liability would not necessarily lead to the recognition of a liability. The liability might not satisfy the recognition criteria.

Initial accounting for variable payments: staff analysis

40. The Interpretations Committee could not reach a consensus regarding the initial accounting for variable payment for the separate acquisition of tangible/intangible assets and it did not make any recommendation to the IASB. However, we think that the IASB should provide clarifications on this issue. We do not think that this can be done through an interpretation, because we think that the requirements in IAS 16/IAS 38 regarding the measurement of cost and IAS 32/IAS 39 regarding contingent settlement provisions need to be clarified. We note that:

    (a) this issue is related to the recognition principles in IAS 32/IAS 39/IFRS 9 and to the definition of a liability;

    (b) there are currently two diverging interpretations of the current requirements in IAS 32/IAS 39/IFRS 9 regarding the timing of accounting for variable payments for the separate purchase of an asset;

    (c) there are differing requirements in current IFRSs regarding the accounting for variable payments. Indeed, if the requirements in IAS 37 were applied by analogy, variable payments that depend on the purchaser's future activity would be recognised as liabilities only when the activity requiring the payment is performed. In contrast, if the requirements in IFRS 3 were applied by analogy, variable payments that depend on the purchaser's future activity would be recognised as liabilities on the date of purchase of the asset.

    (d) the boards could not reach a consensus in the Leases project on whether variable lease payments that are dependent on the lessee's activity meet in principle the initial recognition criteria of a financial liability at lease commencement. Although the boards concluded that those variable lease payments should be excluded from the initial measurement of the liability, we understand that the reasons for this decision for some board members were at least partly based on the difficulties of measuring those variable payments at lease commencement taking into consideration the volume of leases that some entities have (rather than necessarily on whether or not the initial recognition criteria of a financial liability were met).

(e) when dealing with contingent consideration in IFRS 3, the IASB considered that to delay recognition of assets or liabilities that are difficult to measure would cause financial reporting to be incomplete and thus diminish its usefulness in making economic decisions. Nevertheless, when dealing with variable lease payments, the boards considered that variable payments that depend on the lessee's future activity would be too complex to measure and would not provide sufficiently useful information to users to outweigh the cost.

41. As a result, we think that the IASB has at least the two following alternatives for the initial accounting for variable payments for the separate acquisition of a tangible/intangible asset:

(a) Alternative 1: propose to include the fair value of all variable payments in the initial measurement of the liability on the date of purchase of the asset.

(b) Alternative 2: propose to exclude those variable payments that are dependent on the purchaser's future activity from the initial measurement of the liability until the activity is performed.

42. The basis for Alternative 1 would be that the purchaser has an obligation on the date of purchase of the asset to pay the variable payments. The basis for Alternative 2 would be that:

(a) the purchaser does not have an obligation to pay those variable payments that are dependent on the purchaser's future activity until the activity is performed; and/or

(b) to require the recognition of a liability on the date of purchase of the asset for those variable payments that are dependent on the purchaser's future activity would be complex in many cases and would often not provide sufficiently useful information to users to outweigh the cost.

43. We note that variable payments that are dependent on future sales or revenues are common in contracts for the purchase of an asset (such as in licence agreements and service concession arrangements). We think that the reasons put forward by the boards in the Leases project to exclude those variable payments from the initial measurement of the liability (ie the difficulties in measuring those variable payments at lease commencement taking into consideration the volume of leases that some entities have) may also be valid within the context of the separate acquisition of PPE and intangible assets. Indeed, it should be noted that agreements for the separate acquisition of assets (such as in service concession arrangements or licence agreements) typically last between 5 and 50 years.

44. We also note that some of the features of variable payments for the separate acquisition of assets are different from the features of contingent considerations paid in business combinations. Business combinations are one-time, discrete transactions. Contingent considerations in a business combination are typically paid within the next two or three years following the business combination. Acquisitions of assets are common transactions and the corresponding variable payments might be made over a long period (as in leases).

45. Lastly, we note that the IASB considered this issue when developing the definition and recognition criteria for a liability in its project on the Conceptual Framework and proposed different views for the accounting for variable payments that depend on the entity's future actions.

Summary of the Interpretations Committee's decisions regarding the subsequent accounting for variable payments

46. We present below:

    (a) a chart summarising the Interpretations Committee's discussions and decisions taken during its January 2013 meeting. The Interpretations Committee's decisions are shown in red.

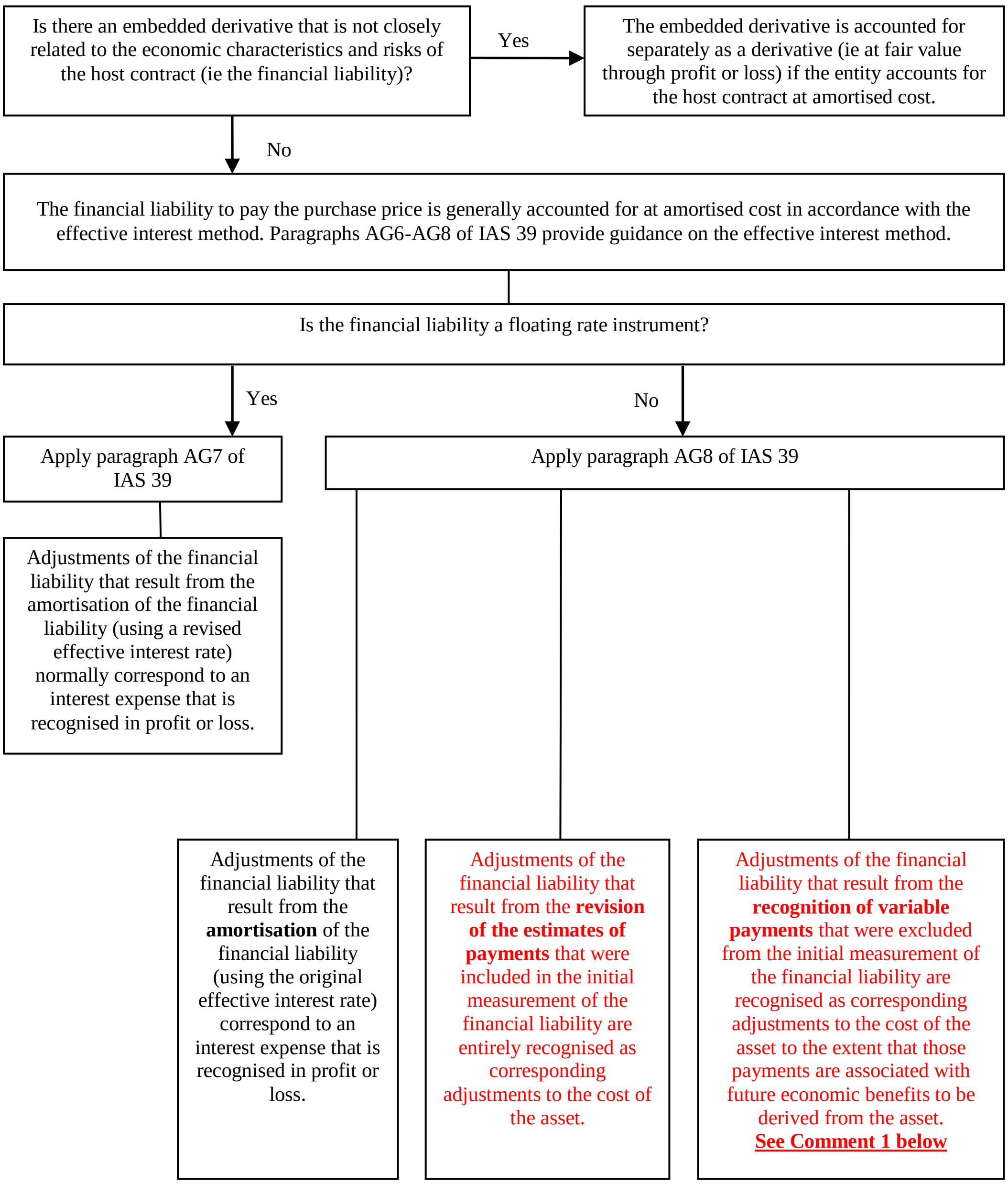
    (b) a detailed analysis of the Interpretations Committee's discussions.

47. It should be noted that the initial accounting for variable payments affects the subsequent accounting for those variable payments:

(a) If the variable payments are recognised on the date of purchase of the asset, then the issue regarding the subsequent accounting is to decide how to account for adjustments of the financial liability that result from the **revision of the estimates of payments**.

(b) If the variable payments are recognised only when the activity requiring the payment is performed , then the issue is to decide how to account for those adjustments of the financial liability that result from the recognition of variable payments that were previously excluded from the initial measurement of the financial liability.

48. As a result, the Interpretations Committee's analysis takes into account both Alternative 1 and Alternative 2.



Comment 1: These proposals apply only if some variable payments are excluded from the initial measurement of the liability.

49. The Interpretations Committee's detailed analysis regarding the subsequent accounting for variable payments is the following:

(a) Embedded derivatives that are not closely related to the economic characteristics and risks of the financial liability should be accounted for separately as derivatives (ie at fair value through profit or loss).

(b) A financial liability arising from the separate purchase of an asset is generally subsequently accounted for at amortised cost in accordance with the effective interest method. Paragraphs AG6-AG8 of IAS 39 provide guidance on the effective interest method.

(c) Paragraph AG7 of IAS 39 applies to the accounting for floating rate instruments. It would therefore apply for example to the accounting for liabilities to make variable payments that are dependent on an interest rate (such as LIBOR). The Interpretations Committee thinks that the remeasurement of the liability in accordance with paragraph AG7 normally corresponds entirely to an interest expense (calculated using the revised EIR) that should be recognised in profit or loss.

(d) Paragraph AG8 of IAS 39 applies to the accounting for financial instruments that are not floating rate instruments. The Interpretations Committee noted that it would therefore apply for example to the accounting for:

(i) a liability to make variable payments that depend on an index that is not analysed as being a floating rate instrument;

(ii) a liability to make variable payments that depend on the purchaser's future activity; and

(iii) a liability to make variable payments if the asset acquired complies with agreed-upon specifications at specific dates in the future.

(e) According to paragraph AG8, remeasurements of the liability that are due to the revision of estimated cash flows do not alter the EIR. The entity recalculates the carrying amount of the liability by computing the present value of estimated future cash flows at the financial instrument's original EIR. The result is that the entity accounts for an **adjustment** to the carrying amount of the liability (referred to as the '**AG8 adjustment**' in this paper). The Interpretations Committee thinks that the interest expense in each period (that is recognised in profit or loss) corresponds to the amount calculated using the original EIR. It also thinks that the AG8 adjustment of the carrying amount of the liability (that relates to the effect of the revision of estimated future cash flows) is not an interest expense (or an interest income). Instead, it thinks that this adjustment relates to the purchase transaction itself (when dealing with variable payments for the separate purchase of an asset).

(f) The Interpretations Committee thinks that the original EIR (within the context of applying paragraph AG8 to the separate acquisition of an asset) should be initially set to equal the purchaser's incremental borrowing rate on the date of purchase of the asset when the implicit interest rate in the purchase contract is not readily determinable. The purchaser's incremental borrowing rate is the interest rate that reflects the rate at which the purchaser could borrow a similar amount in the same currency, for the same duration and with similar collateral as in the purchase agreement.

(g) The Interpretations Committee noted that paragraph AG8 of IAS 39 specifies that the AG8 adjustment should be recognised in profit or loss as income or expense. Some question whether this paragraph prevents this adjustment from being recognised as an adjustment to the cost of the asset acquired in certain circumstances. The Interpretations Committee thinks that the appropriate interpretation of the current requirements of IAS 39 is that an entity should recognise the AG8 adjustment of a financial liability in profit or loss **unless another Standard requires otherwise**. Indeed, it does not think that the fact that paragraph AG8 of IAS 39 specifies that the AG8 adjustment of the liability should be recognised in profit or loss prevents another IFRS from requiring its capitalisation. For example, IAS 23 *Borrowing Costs* requires interest expenses (that are otherwise recognised in profit or loss according to IAS 39) to be **capitalised** in accordance with IAS 23.

(h) The requirements in IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* suggest that the AG8 adjustment should be entirely or partially capitalised in the cost of the asset depending on whether the adjustment is a change of estimate or not.

(i) The Interpretations Committee thinks that if all the variable payments are initially included in the measurement of the liability (ie Alternative 1 described above), the AG8 adjustment corresponds to a **change of estimate** and should be recognised entirely as a corresponding adjustment to the cost of the asset. The Interpretations Committee noted that changes of estimates in IAS 16 and IAS 38 (eg changes in the residual value and the useful life of an asset) are accounted for prospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The Interpretations Committee also noted that this analysis is consistent with the accounting for changes of estimates in IFRIC 1. IFRIC 1 addresses the accounting for changes in decommissioning, restoration and similar liabilities and requires that the cost of an asset should be subsequently adjusted when the decommissioning liability is remeasured (because of changes in the estimated cash flows required to settle the obligation or because of changes in the discount rate). In other words, IFRIC 1 acknowledges that the cost of an asset that includes the initial estimate of the costs of dismantling the asset should be adjusted **after the time of its acquisition or construction**. It should be noted that IFRIC 1 requires a fully prospective treatment (and does not permit a retrospective catch up adjustment) in order to be consistent with other changes in estimates for PPE. See IFRIC 1 paragraphs 5 (a) and BC12-BC18.

(ii) If the variable payments are **not** initially included in the measurement of the liability (ie Alternative 2 described above), the Interpretations Committee noted that the AG8 adjustment of the liability does **not** correspond to a change of estimate. In that case, it thinks that this adjustment should be accounted for as an asset to the extent that the payments are associated with future economic benefits to be derived from the underlying asset. This analysis is consistent with the definition of an 'asset'. It should be noted that this analysis deals with situations where the variable payments are excluded from the initial measurement of the financial liability (ie Alternative 2 described above). This is because the Interpretations Committee could not reach a consensus on whether all variable payments should be included in the initial measurement of the financial liability (see section above). The Interpretations Committee acknowledge that judgement might be required to allocate between past economic benefits and future economic benefits but it does not think that guidance should be provided on how to make this allocation.

50. Examples illustrating how the Interpretations Committee's tentative decisions would be applied are shown in Appendix A. Additional examples are included in Agenda Paper 2 presented at the January 2013 Interpretations Committee's meeting.

51. We understand that the Interpretations Committee's proposals are broadly consistent with the Leases project. Indeed, according to the Exposure Draft published in May 2013 (the ED):

(a) a lessee shall recognise the amount of the remeasurement of the lease liability as an adjustment to the right of use asset (except for remeasurements arising from a change in an index or a rate attributable to the current period that is recognised in profit or loss). See paragraph 43 of the ED.

(b) after the commencement date, a lessee shall recognise in profit or loss, unless the costs are included in the carrying amount of another asset in accordance with other applicable Standards, variable lease payments not included in the lease liability in the period in which the obligation for those payments is incurred. See paragraph 42 (c) of the ED.

52. However, it should be noted that the Leases project is a specific regime and that the lease liability is not initially measured at fair value (whereas a financial liability is initially measured at fair value according to IAS 39/IFRS 9).

Questions to the IASB and next steps

53. The Interpretations Committee decided to recommend to the IASB to propose amendments to current IFRSs regarding the subsequent accounting for variable payments (although it did not reach a consensus on the initial accounting).

54. However, we think that we should first ask the IASB:

    (a) whether it thinks that it should address both the initial accounting and subsequent accounting for variable payments for the separate purchase or assets at the same time; and

    (b) whether it thinks that this is the right time to discuss the accounting for variable payments for the separate purchase or assets.

55. We think that the initial accounting and subsequent accounting for variable payments for the separate purchase or assets are linked and should be addressed comprehensively. We note that the initial accounting for variable payments affects their subsequent accounting. Indeed, if the measurement of the liability initially includes on the date of purchase of the asset all the variable payments, then the liability would need to be adjusted at each reporting date for the revisions in the estimate of the variable payments, including those that are dependent on the purchaser’s future activity. In that case, the issue of whether the adjustment of the liability is an expense or a corresponding adjustment to the cost of the asset is paramount. .

56. If the measurement of the liability initially excludes, on the date of purchase of the asset, variable payments that are dependent on the purchaser’s activity, then the liability would need to be adjusted only in limited circumstances. Indeed, variable payments that are dependent on the purchaser’s future activity would be included in the measurement of the liability only when the corresponding activity requiring the payment is performed. At that date, the amount to be paid would be fixed and

the issue is whether the debit of the liability (on initial recognition of that liability) is an expense or an asset.

57. We also note that the IASB discussed in detail the accounting for variable payments in the Leases project and in the Conceptual Framework project. Furthermore, we think that variable lease payments and variable payments for the separate acquisition of tangible/intangible assets share common characteristics. As a result, we think that the IASB should defer the publication of an exposure draft on the accounting for variable payments for the acquisition of tangible/intangible assets until the proposals of the Exposure Draft *Leases* (published in May 2013) have been redeliberated.

Questions to the IASB

1. Does the IASB agree with the staff recommendation that the discussions regarding the initial accounting for variable payments for the separate acquisition of tangible/intangible assets should be postponed until the Leases proposals have been redeliberated?

2. If not, does the IASB agree with one of the following alternatives:

- Alternative 1: the fair value of all variable payments should be included in the initial measurement of the liability on the date of purchase of the asset (provided that the asset has been received); or
- Alternative 2: variable payments that are dependent on the purchaser's future activity should be excluded from the initial measurement of the liability until the activity is performed.

3. Does the IASB agree with the staff recommendation that initial and subsequent accounting for variable payments should be addressed at the same time?

4. If the IASB thinks that initial accounting does not need to be addressed at the same time as subsequent accounting, does the IASB agree with the Interpretations Committee's recommendations regarding the subsequent accounting for variable payments to amend IFRSs as part of a narrow scope project?

58. If the IASB agrees with the Interpretations Committee's recommendations regarding the subsequent accounting for variable payments, we would propose amendments as part of a narrow-scope project. We would bring back those proposed amendments to a future IASB meeting. It should be noted that the Interpretations Committee developed proposals for the amendments, but we first wanted to discuss the principle of making these amendments with the IASB before bringing detailed proposals. If the IASB agrees to make amendments, we would reflect the IASB's discussions in those proposals.

Appendix A—Simplified examples

59. We provide below simplified examples of variable payments for the separate acquisition of PPE and intangible assets. The objective is to apply the Interpretations Committee's proposals to the accounting for variable payments in various examples. The three following examples are presented:

    (a) Example 1: variable payments that are made if the asset acquired complies with agreed-upon specifications at specific dates in the future;

    (b) Example 2: variable payments that are dependent on revenues derived from the use of the asset;

    (c) Example 3: variable payments that are made if a milestone is reached in a research and development project;

Example 1: variable payments that are made if the asset acquired complies with agreed-upon specifications at specific dates in the future

60. Entity A acquires a communication satellite on 1 January 20X0. Entity A agrees to make a first fixed payment of CU100 at the date of acquisition and one additional payment of CU121 if the communication satellite is **capable** of operating according to a standard performance **two** years after the satellite has been in operation. According to the purchase contract, if the satellite is not capable of operating at the agreed standard performance on 31 December 20X1, the additional payment is reduced or not made. On 1 January 20X0, Entity A expects to make an additional payment of CU121.

61. For the purposes of this example, assume that:

    (a) Entity A's incremental borrowing rate at the date of acquisition is 10%;

    (b) During 20X0, Entity A revises its estimates and expects to make an additional payment of CU90 because the satellite is not capable of operating at the standard performance agreed in the contract. The actual additional payment on 31 December 20X1 is CU90.

    (c) The satellite will stay in operation for a five-year period.

Initial accounting:

62. The additional payment is not dependent on the purchaser's future activity. It is dependent on whether the satellite is capable of operating at an agreed standard performance. As a result, the fair value of the estimated additional payment, ie CU100 (the fair value of CU121 discounted at a rate of 10%) is initially included in the measurement of the asset and liability. On 1 January 20X0, Entity A recognises an asset and a liability as follows:

Dr Asset		CU200	
	Cr Liability		CU100
	Cr Cash		CU100

63. The table below illustrates how the liability is **expected** to be amortised (on the basis of **expected** cash flows) at the date of the initial accounting (ie 1 January 20X0):

Year	Initial carrying amount	Interest expense (at 10%)	Expected payments	AG8 adjustment	Ending carrying amount
20X0	CU100	CU10	0	0	CU110
20X1	CU110	CU11	CU(121)	0	0

Subsequent accounting:

64. The liability is accounted for at amortised cost in accordance with paragraph AG8 of IAS 39. The EIR is 10%. The table below illustrates how the liability is **actually** amortised (on the basis of **actual** cash flows):

Year	Initial carrying amount	Interest expense (at 10%)	Expected payments	AG8 adjustment	Ending carrying amount
20X0	CU100	CU10	0	CU(28)	CU82
20X1	CU82	CU8	CU(90)	0	0

65. Because the satellite is not capable of operating at the standard performance agreed in the contract, Entity A revises its estimate during 20X0 and expects to make an additional payment of CU90. As a result, the AG8 adjustment in 20X0 is CU28 (so that the EIR remains constant at 10%). This adjustment is entirely recognised as a corresponding adjustment to the cost of the asset. As a result, the cost of the asset is reduced and this reduction will affect the depreciation expense

of the current and future periods. It should be noted that the calculation of the depreciation expense should be revised prospectively. However, for the purpose of this simplified example, we assume that Entity A prepares only annual financial statements and that Entity A revises the calculation of the depreciation expense for the current period, ie 20X0. As a result, the depreciation expense in 20X0 is 34.4 ((200-28)/5). On 31 December 20X0, Entity A makes the following entries:

Dr Interest expense (EIR=10%)	CU10	
Cr Liability		CU10
Dr Liability (AG8 Adjustment)	CU28	
Cr Asset		CU28
Dr Depreciation Expense	CU34.4	
Cr Asset (depreciation)		CU34.4

Example 2: variable payments that are dependent on revenues derived from the use of the asset

66. A 3-year service concession arrangement specifies that Operator B has a right to charge users for a public service in exchange for annual payments made to a grantor. Payments correspond to 20% of the annual revenues generated though the sale of the public service to the users during the 3-year service concession period. The concession starts on 1 January 20X0. Payments are made at the end of each calendar year.

67. For the purposes of this example, assume that:

    (a) Operator B's incremental borrowing rate is 10% on 1 January 20X0; and

    (b) the variable payments are part of the consideration to acquire an intangible asset in accordance with IFRIC 12.

68. The actual and expected payments are the following:

	Expected payments as at				
Year	**1.1.20X0**	**1.1.20X1**	**1.1.20X2**	**Actual revenues**	**Actual payments**
20X0	**CU8**	**0**	**0**	**CU40**	**CU8**
20X1	**CU12**	**CU12**	**0**	**CU60**	**CU12**
20X2	**CU15**	**CU12**	**CU12**	**CU60**	**CU12**

69. The Interpretations Committee could not reach a consensus on the initial accounting for variable payments. As a result, we present two different alternatives:

(a) Alternative 1: the fair value of all variables payments is included in the initial measurement of the liability on the date of purchase of the asset.

(b) Alternative 2: variable payments that depend on the purchaser's future activity are excluded from the initial measurement of the liability.

Alternative 1: the fair value of all variable payments is initially included in the measurement of the liability

Initial accounting:

70. The fair value of expected variable payments is initially included in the measurement of the asset and liability on the date of purchase of the asset. The fair value is CU28.5 (it is the fair value of the three expected payments of CU8, CU12 and CU15 discounted at a rate of 10%). As a result, Operator B initially accounts for an asset and a liability as follows:

Dr Intangible asset		CU28.5	
	Cr Liability		CU28.5

71. The table below shows how the liability is expected to be amortised (on the basis of the expected payments).

Year	Initial carrying amount	Interest expense (at 10%)	Expected payments	AG8 adjustment	Ending carrying amount
20X0	CU28.5	CU2.8	CU(8)	0	CU23.3
20X1	CU23.3	CU2.3	CU(12)	0	CU13.6
20X2	CU13.6	CU1.4	CU(15)	0	0

Subsequent accounting:

72. The liability is accounted for at amortised cost in accordance with paragraph AG8 of IAS 39. The EIR is 10%. In 20X1, the expected payments are revised and the revised expected payments equal the actual payments. The table below shows how the liability is amortised:

Year	Initial carrying amount	Interest expense (at 10%)	Actual payments	AG8 adjustment	Ending carrying amount
20X0	CU28.5	CU2.8	CU(8)	0	CU23.3
20X1	CU23.3	CU2.3	CU(12)	CU(2.7)	CU10.9
20X2	CU10.9	CU1.1	CU(12)	0	0

73. In 20X1, the liability is adjusted, because the expected payments are revised. Under the Interpretations Committee's proposals, this adjustment would be entirely accounted for as a corresponding adjustment to the cost of the asset. It should be noted that the calculation of the depreciation expense should be revised prospectively. For the purpose of this example, we assume that Entity B prepares only annual financial statements and revises the calculation of the depreciation expense for the current period, ie 20X1. As a result, the depreciation expense for 20X0 is CU9.5 (CU28.5/3) and the depreciation expense for 20X1 is revised prospectively. On 31 December 20X0, Operator B makes the following entries:

Dr Interest expense	CU2.8	
Cr Liability		CU2.8
Dr Liability (payment)	CU8	
Cr Cash		CU8

<u>Alternative 2: variable payments that depend on the purchaser's future activity are excluded from the initial measurement of the liability</u>

<u>Initial accounting:</u>

74. Variable payments are not included in the initial measurement of the asset and liability because they are dependent on the purchaser's future activity (the generation of future revenues). There are no amounts to record on 1 January 20X0.

<u>Subsequent accounting:</u>

75. Operator B recognises a liability when the corresponding revenues requiring the payments are generated. In that case, the debit side of the liability should be accounted for as an asset to the extent that it relates to future economic benefits. In this example, the debit side of the liability is an expense, because each payment made at the end of a calendar year is related to the current period (ie it is related to

the revenues generated in the current period). As a result, Operator B recognises the following entries in 20X0:

Dr Cash	CU40	
Cr Revenues		CU40
Dr Expense (concession fee)	CU8	
Cr Cash		CU8

Condensed data and comparison

		Expenses Alternative 1			**Expenses Alternative 2**
Year	**Actual revenues**	**Interest expense**	**Depreciation**	**Total**	**Concession fee**
20X0	**CU40**	**CU2.8**	**CU9.5**	**CU12.3**	**CU8**
20X1	**CU60**	**CU2.3**	**CU8.15**	**CU10.45**	**CU12**
20X2	**CU60**	**CU1.1**	**CU8.15**	**CU9.25**	**CU12**
Total	**CU160**	**CU6.2**	**CU25.8**	**CU32**	**CU32**

Example 3: variable payments that are made if a milestone is reached in a research and development project

76. On 1 January 20X0 Entity C acquires a patent related to a new compound and agrees to make a first fixed payment of CU100 at the date of acquisition. Entity C intends to use the compound in order to develop a new drug as part of a research and development project. Entity C has agreed to make an additional payment of CU55 to the vendor if an approval to sell the new drug in a specific market is obtained. Entity C expects to make the payment on 31 December 20X0 (one year after the acquisition of the patent).

77. For purposes of this example, assume that the patent acquired meets the definition of an intangible asset in accordance with IAS 38 and that the approval is obtained on 31 December 20X1 (ie **two** years after the acquisition of the patent and one year later than expected). The additional payment of CU55 is made when the approval is obtained. Entity C's incremental borrowing rate is 10% (which reflects the rate at which Entity C could borrow). Entity C expects to sell the new drug on the market for a five-year period (following the approval).

78. The Interpretations Committee could not reach a consensus on the initial accounting for variable payments. As a result, we present two different alternatives:

(a) Alternative 1: the fair value of all variable payments is included in the initial measurement of the liability on the date of purchase of the asset.

(b) Alternative 2: variable payments that depend on the purchaser's future activity are excluded from the initial measurement of the liability.

Alternative 1: the fair value of all variable payments is initially included in the measurement of the liability

Initial accounting:

79. The fair value of the expected variable payments is initially included in the measurement of the asset and liability on the date of purchase of the asset. The fair value of the expected additional payment on 1 January 20X0 is CU50 (CU55/1.1), because Entity C expects to make the payment one year after the acquisition of the patent. As a result, on 1 January 20X0, Entity C initially accounts for an asset and a liability as follows:

Dr Intangible asset	CU150	
Cr Liability		CU50
Cr Cash		CU100

80. The table below shows how the liability is expected to be amortised.

Year	Initial carrying amount	Interest expense (at 10%)	Expected payments	AG8 adjustment	Ending carrying amount (adjusted)
20X0	CU50	CU5	CU(55)	0	0

Subsequent accounting:

81. The liability is accounted for at amortised cost in accordance with paragraph AG8 of IAS 39. The EIR is 10%. In 20X0, Entity C revises its estimate about the timing of the additional payment (ie it expects to make the additional payment on 31 December 20X1). As a result, the liability is adjusted to reflect the fact that the additional payment is paid later than expected. The table below shows how the liability is amortised:

Year	Initial carrying amount	Interest expense (at 10%)	Actual/Expected payments	AG8 adjustment	Ending carrying amount (adjusted)
20X0	CU50	CU5	0	CU(5)	CU50
20X1	CU50	CU5	CU(55)	0	0

82. The AG8 adjustment of CU5 is recognised entirely as a corresponding adjustment to the cost of the asset, because it is a change of estimate. As a result, the cost of the intangible asset after adjustment is CU145 (versus CU155 in Case A). On 31 December 20X0, Entity A makes the following entries:

Dr Interest expense (EIR=10%)	CU5	
Cr Liability		CU5
Dr Liability (AG8 Adjustment)	CU5	
Cr Intangible asset		CU5

83. On 31 December 20X1, Entity A makes the following entries:

Dr Interest expense (EIR=10%)	CU5	
Cr Liability		CU5
Dr Liability	CU55	
Cr Cash		CU55

Alternative 2: variable payments that depend on the purchaser's future activity are excluded from the initial measurement of the liability

Initial accounting:

84. Entity C initially includes in the initial measurement of the asset the fair value of the first fixed payment to be made. The additional payment is not included in the initial measurement of the asset and liability, because this payment is dependent on the purchaser's future activity (a research and development project). As a result, on 1 January 20X0, Entity C makes the following entries:

Dr Intangible asset	CU100	
Cr Cash		CU100

Subsequent accounting:

85. Entity C subsequently includes in the measurement of the liability the fair value of the additional payment when the approval to sell the new drug on the market is obtained. Changes in the measurement of the liability that are due to this additional payment are recognised as an adjustment to the cost of the intangible asset (the compound). Those changes reflect additional costs associated with acquiring the compound and are related to future economic benefits (the future revenues expected to be generated through the sales of the new drug in the future). As a result, at the date when the approval is obtained (ie 31 December 20X1), Entity C makes the following entries:

Dr Intangible asset	CU55	
Cr Cash		CU55