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 PPE and intangible assets		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a request to address an issue that is related to contractual payments to be made by an operator under a service concession arrangement within the scope of IFRIC 12 *Service Concession Arrangements*. Specifically, the submitter requested that the Interpretations Committee should clarify in what circumstances (if any) those payments should:

   (a) be included in the measurement of an asset and liability at the start of the concession; or

   (b) be accounted for as executory in nature (ie be recognised as expenses as they are incurred over the term of the concession arrangement).

2. The Interpretations Committee noted that the issue of variable concession fees made by an operator under a service concession arrangement is linked to the broader issue of variable payments for the separate acquisition of PPE and intangible assets outside of a business combination. This broader issue was previously discussed, but not concluded on, by the Interpretations Committee in 2011.

3. At the September 2012 meeting, the Interpretations Committee observed that there is currently diversity in practice regarding the accounting for variable payments for the separate purchase of PPE and intangible assets. The Interpretations Committee discussed whether the principles that the IASB is developing in the Leases project should be used as the basis for the accounting for those variable payments. Some Interpretations Committee members expressed reservations about applying the principles in the Leases project to the accounting for such variable payments, because the Leases project is not yet completed and the timing of publication of the final Standard is uncertain.

4. The Interpretations Committee directed the staff to prepare a paper that would present the different models discussed in previous meetings by the Interpretations Committee for the accounting for variable payments. The Interpretations Committee also directed the staff to focus such a paper on the accounting for the debit side of the transaction (rather than on the recognition and measurement of the liability) and in doing so to consider whether there are circumstances in which the remeasurement of the liability should be included as an adjustment to the cost of the asset.

5. The paper discusses below:

    (a) the requirements in the current IFRSs regarding the accounting for variable payments for the separate purchase of an asset;

    (b) the requirements in IFRS 3 *Business Combinations* regarding the accounting for contingent consideration; and

    (c) the tentative decisions taken so far by the boards in the Leases project regarding the accounting for variable lease payments.

Structure of the paper

6. The structure of the paper is as follows:

    (a) Examples of 'variable payments';

    (b) Initial accounting for variable payments;

(c) Subsequent accounting for variable payments;

(d) Amendments to IFRIC 12.

Examples of 'variable payments'

7. We provide below examples of variable payments for the separate acquisition of PPE and intangible assets. A variable payment refers to a payment that is not fixed. Examples of variable payments include:

(a) Variable payments that are dependent on an index or a rate (such as LIBOR 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. 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 specific dates in the future a specific performance agreed with the seller. These payments are not dependent on the purchaser's future activity.

Initial accounting for variable payments

Initial accounting for variable payments according to current IFRSs

8. We note that the obligation to pay a variable payment arises from a contract. As a result, a variable payment should be accounted for in accordance with the requirements in IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*.

9. 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.

10. 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).

11. As a result, 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. We observe 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:

    (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.

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

12. Some 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. Proponents of this accounting point to IAS 32.

13. 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).

14. 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.

15. 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 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) are 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

16. Proponents of Alternative 2 think that 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. They note that paragraph 25 of IAS 32 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 and therefore did not address the issue of executory contracts.

17. Proponents of Alternative 2 think that variable payments for the separate purchase of an asset that are dependent on the purchaser's future activity are executory contracts until the activity requiring the payment is performed. As a result, the asset and the financial liability related to those variable payments should not be recognised until the activity requiring the payment is performed.

18. They point to the guidance in IAS 39 regarding executory contracts. Paragraph AG35 (b) of IAS 39 specifies that 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. For example, the entity that places the order does not recognise a liability until the ordered goods or services have been shipped, delivered or rendered. Paragraph 5 of IAS 39 specifies that contracts to buy or sell a non-financial item that were entered into and continue to be held for the purpose

of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements are not within the scope of IAS 39. This is because those contracts are accounted for as executory contracts even if a right to purchase has been granted to the purchaser (see also Guidance on implementing IAS 39, Section A *Scope*, paragraph A.1).

19. Proponents of Alternative 2 also point to the guidance in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* regarding executory contracts and to the definition of a liability in IAS 37. Paragraph 3 of IAS 37 describes executory contracts as contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. IAS 37 does not apply to executory contracts unless they are onerous. 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.

20. As a result, proponents of Alternative 2 think that variable payments that are dependent on the purchaser's future activity, such as generating sales or reaching a milestone in a research and development project, would not meet the recognition criteria of a liability until the corresponding activity is performed (ie until the sales are generated or the milestone is reached).

21. 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

22. We note that the liability to make lease payments is a financial liability. This liability is, however, accounted for in accordance with the requirements in IAS 17 *Leases* (and not IAS 39). The accounting for the liability to make lease payments was discussed in detail in the Leases project.

23. 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* exposure draft). However, after considerable submission of views from interested parties, 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).

24. However, we understand that the members of the two boards came to that conclusion for different reasons:

    (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 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 (ie the contract is executory until the activity is performed). This is because those payments are avoidable.

25. 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; 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

26. 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.

27. 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.

28. 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 the 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: staff recommendation

29. We do not think that the Interpretations Committee should address this issue through an interpretation. Indeed, 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 conflicting 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 (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.

30. As a result, we think that the Interpretations Committee has the two following alternatives for the initial accounting for variable payments:

(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.

31. 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.

32. We support Alternative 2. Indeed, 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) are also valid within the context of the separate acquisition of PPE and intangible assets.

33. If the Interpretations Committee cannot reach a consensus, we will report this issue to the IASB. We note that the IASB decided to restart the project on the Conceptual Framework. We think that the IASB should consider this issue when developing the definition and recognition criteria for a liability in its project.

Questions to the Interpretations Committee
Does the Interpretations Committee agree with: - 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; or - Alternative 2 (staff recommendation): 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.

Subsequent accounting for variable payments

Link between initial accounting and subsequent accounting

34. We think that the initial accounting of 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.

35. 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. If the Interpretations Committee were to decide that all subsequent adjustments of the liability should be recognised in profit or loss, this would presumably create volatility in profit or loss because of the periodic re-estimates of cash flows (in particular for those variable payments that are dependent on the purchaser's future activity, such as sales or revenues).

36. 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.

Subsequent accounting for variable payments according to current IFRSs

37. The core issue is whether the remeasurement of the financial liability to make variable payments should be recognised in profit or loss, or should be included as an adjustment to the cost of the asset.

38. However, we note that the first issue is to decide whether there is an **embedded derivative** that should be separated from the host contract (ie the financial liability) and accounted for as a derivative in accordance with IAS 39/IFRS 9 (ie at fair value through profit or loss).

39. The second issue is to decide whether the remeasurement of a financial liability accounted for at amortised cost corresponds to:

    (a) an **interest expense** that relates to the financing component of the purchase transaction; and/or

(b) a cost that relates to the **purchase transaction** itself.

40. The third issue is to decide whether the remeasurement of the liability that relates to the purchase transaction itself (if any) should be **capitalised** or not.

Does the remeasurement of the liability correspond to an embedded derivative that should be separated from the financial liability?

41. We note that guidance on embedded derivative is set out in IAS 39 (paragraphs 10-13) and IFRS 9 (paragraph 4.3). In applying that guidance, an entity should first determine whether there is an embedded derivative that should be separated from the host contract (ie the financial liability accounted for at amortised cost) and accounted for as a derivative in accordance with IAS 39/IFRS 9 (ie at fair value through profit or loss).

42. An embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

43. It should be noted that if the economic characteristics and risks of the embedded derivative are closely related to the economic characteristics and risks of the host, the embedded derivative should **not** be separated (see paragraphs B4.3.1-B4.3.8 of IFRS 9 and AG30-AG33 of IAS 39).

44. Moreover, if the cash flows are modified according to a non-financial variable that is specific to a party to the contract, then the instrument does not meet the definition of a derivative (and thus should not be separated). Profits, revenues, sales or other indicators such as EBITDA of the entity are generally considered to be non-financial variables that are specific to a party to the contract.

<u>Does the remeasurement of the liability correspond to an interest expense?</u>

45. Assuming that the variable payments are not caused by an embedded derivative that should be accounted for separately from the host contract, the financial liability to make variable payments would be generally measured at amortised cost using the effective interest method (see IAS 39 paragraph 47 and IFRS 9 paragraph 4.2.1). The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the **interest income or interest expense** over the relevant period. Paragraphs AG7-AG8 of IAS 39 provide guidance on the application of the effective interest method.

46. Paragraph AG7 of IAS 39 applies to the accounting for floating rate instruments. It would therefore apply to the accounting for a liability to make variable payments that depend on an index or a rate that is analysed as being a floating rate instrument. According to paragraph AG7, periodic re-estimating of cash flows to reflect movements in market rates of interest alters the effective interest rate. Re-estimating the future interest payments normally has no significant effect on the carrying amount of the liability. As a result, we think that the remeasurement of the liability in accordance with paragraph AG7 normally corresponds to an **interest expense** (calculated using the revised effective interest rate) that should be recognised in profit or loss.

47. Paragraph AG8 of IAS 39 applies to the accounting for instruments that are **not** floating rate instruments. It would therefore apply for example to the accounting for:

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

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

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

48. According to paragraph AG8, remeasurements of the liability that are due to the revision of estimated cash flows do not alter the effective interest rate. 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 effective interest rate and the corresponding **adjustment** is recognised in profit or loss **as income or expense**. As a result, we note that there are two different types of remeasurements:

    (a) the interest expense calculated using the original effective interest rate (that is recognised in profit or loss); and

    (b) the **adjustment of the liability** (accounted for as income or expense) that relates to the effect of the revision of estimated future cash flows.

49. We do not think that this last adjustment corresponds to an interest expense according to the requirements in IAS 39. Instead, we think that this adjustment resulting from the application of paragraph AG8 relates to the purchase transaction itself (when dealing with variable payments for the separate purchase of an asset). The question of whether this adjustment should be capitalised is discussed in the section below.

Does IAS 39/IFRS 9 require that the remeasurement of the liability that relates to the purchase transaction itself (if any) should be recognised in profit or loss?

50. As mentioned above, an initial analysis of paragraph AG8 would suggest that the adjustment of the liability that is due to the revision of estimated cash flows should be recognised in profit or loss as **income or expense**. However, we do not think that the fact that IAS 39 specifies that the adjustment of the liability should be recognised in profit or loss prevents another IFRS from requiring the capitalisation of this adjustment.

51. Indeed, for example, IAS 39 specifies that borrowing costs are interest expenses (and thus that those borrowing costs should be recognised in profit or loss). However, IAS 23 *Borrowing Costs* requires that an entity should capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the asset. According to IAS 23

(paragraphs 5 and 6), borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds and may include **interest expense calculated using the effective interest** method as described in IAS 39. IAS 23 therefore requires interest expenses (that are otherwise recognised in profit or loss according to IAS 39) to be **capitalised** in accordance with IAS 23. In other words, the fact that IAS 39 specifies that finance costs are interest expenses does not prevent IAS 23 from requiring the capitalisation of the interest expense.

52. Moreover, we note that IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* addresses the accounting for changes in decommissioning, restoration and similar liabilities and also requires an adjustment to the cost of the asset in a similar situation. However, we acknowledge that IAS 37 (unlike IAS 39) does not specify whether the debit side of the liability should be accounted for as an asset or as an expense (see IAS 37 paragraph 8).

53. Consequently, we think that the appropriate interpretation of the current requirements in IAS 39 is that an entity should recognise interest expenses and adjustments of the financial liability as described in paragraph AG8 of IAS 39 in profit or loss **unless another IFRS requires otherwise**.

54. When dealing with variable payments for the separate purchase of PPE and intangible assets, the question that follows is to decide whether IAS 16 and IAS 38 would require, in certain circumstances, the adjustment of the liability as described in paragraph AG8 of IAS 39 to be accounted for as a corresponding adjustment to the cost of the asset.

Does IAS 16/IAS 38 require that the remeasurement of the liability that relates to the purchase transaction itself (if any) should be capitalised?

55. According to IAS 16 and IAS 38:

> Cost is 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, where applicable, the amount attributed to that asset when initially

recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2 *Share-based Payment*.

56. We note that 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**. Indeed, according to IFRIC 1, the asset is 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).

57. As a result, we think that the cost of an asset should be adjusted to reflect the subsequent adjustment of the liability that relates to the purchase transaction itself (ie the adjustment as described in paragraph AG8 of IAS 39). The next question is whether this adjustment should be entirely capitalised or not.

58. We note that this adjustment could be recognised:

(a) entirely as a corresponding adjustment to the cost of the asset (as in IFRIC 1); or

(b) as an adjustment to the cost of the asset only to the extent that it relates to future economic benefits to be derived from the asset (as in the Leases project). Adjustments that relate to past or current economic benefits would be recognised in profit or loss.

59. We think that the accounting for the adjustment of the liability as described in paragraph AG8 of IAS 39 is closely linked to the initial accounting for the variable payments. We think that if the variable payments are initially included in the measurement of the liability, this adjustment corresponds to a **change of estimate**, and that change should be recognised prospectively as in IFRIC 1 (ie entirely as a corresponding adjustment to the cost of the asset).

60. If the variable payments are **not** initially included in the measurement of the liability, the adjustment of the liability as described in paragraph AG8 of IAS 39 does **not** correspond to a change of estimate. In that case, we think that this adjustment should be accounted for as an asset to the extent that it relates to future economic benefits. In our view, this is consistent with the definition of an asset. This is also consistent with the conclusions of the boards in the Leases project.

We acknowledge that judgement might be required to allocate between past economic benefits and future economic benefits but we do not think that the Interpretations Committee should give detailed guidance on how to make this allocation.

Subsequent accounting for variable payments in the Leases project

61. In the Leases project, a lessee would subsequently measure the liability to make lease payments at amortised cost. A lessee would remeasure the carrying amount of the liability to make lease payments, which includes variable payments dependent on an index or a rate, based on the index or rate at the end of the reporting period.

62. Lessees would reflect changes in expected lease payments that depend on an index or a rate:

    (a) in profit or loss to the extent that those changes relate to the current period; and

    (b) as an adjustment to the right-of-use asset to the extent that those changes relate to future periods.

63. The allocation between current and future periods would be based on the pattern in which the economic benefits of the right-of-use assets will be consumed or were consumed.

64. We understand that variable payments that are not included in the initial measurement of the liability would be subsequently recognised as an expense when they are incurred (ie when the contingent event occurs), unless they relate to future periods (in which case they are recognised as an adjustment to the right-of-use asset).

65. It should be noted that, when initially measuring the liability to pay lease payments that depend on an index or a rate, the lessee would use the index or rate at the date of commencement of the lease (ie the spot rate) to decide the initial measurement of variable payments that depend on an index or a rate. A lessee would update the discount rate only when there is a change in lease payments that

is due to a change in reference interest rates (if variable lease payments are based on those reference interest rates). The lessee would determine the revised discount rate using the rate at the date of reassessment.

Subsequent accounting for contingent consideration in IFRS 3

66. According to IFRS 3 (paragraph 58), some changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date. The acquirer shall retrospectively adjust the provisional amounts of assets and liabilities recognised at the acquisition to reflect such changes, provided that those adjustments are made within a 12 month period following the acquisition date.

67. Changes resulting from events **after the acquisition date**, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments **in profit or loss** (or in other comprehensive income in limited circumstances), provided that the liability to pay the contingent consideration is a financial liability within the scope of IAS 39.

68. In other words, the boards concluded that subsequent changes in the fair value of a liability for contingent consideration do not affect the acquisition-date fair value of the consideration transferred or the goodwill determined on the acquisition date. Instead, those subsequent changes in value are generally directly related to post-combination events and changes in circumstances related to the combined entity.

69. We note that according to IFRS 3 (2008), an acquirer should in principle measure all components of the business combination (including any non-controlling interests in an acquiree) at their acquisition date fair values. Although IFRS 3 also permits an acquirer to measure any non-controlling interests as the non-controlling interests' proportionate share of the acquiree's identifiable net assets, we do not think that the current IFRS 3 is based on a cost model. As a

result, we are not convinced that IFRS 3 should be applied by analogy to the accounting for variable payments for the separate purchase of an asset (because the cost model is used in that case). We also note that according to IFRS 3 (2004), ie the 'old version' of IFRS 3 based on the cost of the business combination, goodwill was subsequently adjusted (without any limitation of time) when the cost of the business combination was adjusted because of contingent payments.

Subsequent accounting: staff recommendation

70. As explained in detail above, we think that:

(a) the adjustment of the liability as described in paragraph AG8 of IAS 39 relates to the purchase transaction itself (and is not an interest expense);

(b) this adjustment should be recognised in profit or loss unless another Standard requires otherwise;

(c) the requirements in IAS 16/IAS 38 and IFRIC 1 suggest that this 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.

71. We do not think that the current IFRS 3 should be applied by analogy, because it is not based on a cost model. We also think that this outcome is consistent with the tentative conclusions of the boards in the Leases project.

72. We think that the Interpretations Committee has the following alternatives:

(a) Alternative A: propose that the adjustment of the liability as described in paragraph AG8 of IAS 39 should be recognised in profit or loss;

(b) Alternative B: propose that the adjustment of the liability as described in paragraph AG8 of IAS 39 should be recognised as a corresponding adjustment to the cost of the asset (entirely when the adjustment is a change of estimate and to the extent that it relates to future economic benefits to be derived from the asset when the adjustment is not a change of estimate).

We support Alternative B for the reasons explained above. If the Interpretations Committee cannot reach a consensus, we will report this issue to the IASB.

Questions to the Interpretations Committee
Does the Interpretations Committee agree with: - Alternative A: the adjustment of the liability as described in paragraph AG8 of IAS 39 should be recognised in profit or loss; or - Alternative B (staff recommendation): the adjustment of the liability as described in paragraph AG8 of IAS 39 should be recognised as a corresponding adjustment to the cost of the asset (entirely when the adjustment is a change of estimate and to the extent that it relates to future economic benefits to be derived from the asset when the adjustment is not a change of estimate).

Amendments to IFRIC 12

73. We note that the Interpretations Committee tentatively decided to amend IFRIC 12 during its March and May 2012 meetings. We think that the Interpretations Committee should proceed with these amendments, even if the Interpretations Committee does not reach a conclusion on the accounting for variable payments for the separate purchase of assets.

74. We also note that the Interpretations Committee tentatively agreed that it would prefer to publish the Exposure Draft of amendments to IFRIC 12 (and any other IFRSs) at the same time as the re-exposure document for Leases is published.