STAFF PAPER

September 2012

IFRS Interpretations Committee Meeting

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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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 payments 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 by the Interpretations Committee in 2011, but no conclusion was reached at that time.

3. At the May 2012 meeting, the majority of the Interpretations Committee members agreed that the principles that the IASB is developing in the Leases project regarding variable payments should be used as the basis for the accounting for variable payments for the separate acquisition of PPE and intangible assets.

4. The Interpretations Committee directed the staff to prepare a paper which would consider:

   (a) whether the characteristics of variable payments for the separate acquisition of PPE and intangible assets are similar to the characteristics of variable payments in leases;

   (b) what amendments would need to be made to IFRSs to enable the accounting for variable payments for the separate acquisition of PPE and intangible assets to be consistent with the principles in the Leases project; and

   (c) whether the principles used in the Leases project for variable payments would be preferable to the principles used in IFRS 3 *Business Combinations* for contingent payments.

Structure of the paper

5. The structure of the paper is as follows:

   (a) Models for the accounting for variable payments;

   (b) the staff's recommendation: apply a model similar to the Leases model;

   (c) Amendments needed in the current literature in order to account for variable payments for the separate acquisition of PPE and intangible assets consistently with the requirements in the Leases project;

   (d) Next steps;

   (e) Appendix A: Proposed requirements in the Leases project regarding the accounting for variable payments;

   (f) Appendix B : Examples (application of the staff's proposals to the accounting for variable payments for the separate acquisition of PPE or intangible assets);

(g) Appendix C: Considerations regarding other models.

Models for the accounting for variable payments

6. In this section, the objective is to identify the models that could be used for the accounting for variable payments for the separate acquisition of PPE and intangible assets. Thus, the objective is not to restate what the accounting under the current literature is. In our view, there are at least five models that could be used:

   (a) the Leases model, based on the tentative decisions taken so far by the boards in the Leases project;

   (b) the financial liability model, based on the principles in IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* on the accounting for a financial liability;

   (c) the IFRS 3 model, based on the accounting for contingent consideration in IFRS 3;

   (d) the IAS 16/IAS 37 model, based on the principles in IAS 16 *Property, Plant and Equipment*, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*; and

   (e) the 'expensed as incurred' model.

Leases model

7. Initial accounting: variable payments that are in substance fixed lease payments (but that are structured as variable lease payments in form), and payments that depend on an index or a rate, are included in the initial measurement of the asset and liability. All the other variable payments are excluded from the initial measurement. Variable payments that are dependent on future activity (such as future revenues derived from the use of the asset) are therefore excluded from the

initial measurement of the asset and liability. Variable payments that are recognised are measured at their present value.

8. Subsequent accounting: the liability is accounted for at amortised cost. The remeasurement of the liability arising from changes in expected payments is accounted for:

   (a) in P/L 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, or if the allocation between current and future periods cannot be reliably determined.

9. As a result, we understand that variable payments that are not included in the initial measurement of the liability are subsequently recognised as an expense when they are incurred (ie when the contingent event occurs), unless they relate to future periods.

10. The proposed requirements in the Leases project regarding the accounting for variable payments, and the rationale underlying the conclusions of the boards, are described in detail in Appendix A.

Financial liability model

11. Initial accounting: all variable payments are included in the initial measurement of the asset and liability. Variable payments are initially measured at fair value.

12. Subsequent accounting: the liability is accounted for at amortised cost. The remeasurement of the liability is accounted for in P/L.

IFRS 3 model

13. Initial accounting: all variable payments are included in the initial measurement of the asset and liability. Variable payments are initially measured at fair value.

14. Subsequent accounting: the liability to make variable payments is accounted for at fair value. The remeasurement of the liability is accounted for:

(a) as an adjustment to the cost of the asset for *measurement period adjustments* that occur during the measurement period; or

(b) in P/L in all other cases.

IAS 16/IAS 37 model

15. Initial accounting: variable payments are included in the initial measurement of the asset and liability to the extent that they meet the recognition criteria in IAS 37. Variable payments that are included in the initial measurement of the asset and liability are measured at the best estimate of the payments to be made.

16. In our view, variable payments that are dependent on the purchaser's future activity (such as future revenues derived from the use of the asset purchased) would presumably not meet the recognition criteria in IAS 37. According to paragraph 19 in IAS 37, it is only those obligations arising from past event existing independently of an entity's future actions that are recognised as provisions. Consequently, under the IAS 16/IAS 37 model, those variable payments would be excluded from the initial measurement of the asset and liability.

17. Subsequent accounting: if a liability were recognised, it would be remeasured at the best estimate of the payments to be made. The remeasurement of the liability is accounted for prospectively as an adjustment to the cost of the asset (as required in IFRIC 1).

Expensed as incurred model

18. Initial accounting: all variable payments are excluded from the initial measurement of the asset and liability.

19. Subsequent accounting: variable payments are accounted for in P/L when they are incurred (ie when the contingent event occurs).

Staff's recommendation: apply a model similar to the Leases model

20. We think that there are three main issues regarding the accounting for variable payments. These issues are the same for lease contracts and for contracts for the purchase of PPE or intangible assets, and are the following:

    (a) First issue: should all variable payments be included in the initial measurement of the asset and liability?

    (b) Second issue: should the remeasurement of the liability be always recognised in P/L?

    (c) Third issue: should the remeasurement of a liability whose cash flows are linked to an index or a rate be recognised as an adjustment to the cost of the asset?

First issue: should all variable payments be included in the initial measurement of the asset and liability?

21. The first issue is whether the lessee or the purchaser of an asset should initially include, in the measurement of the asset and liability, all the variable payments to be made in the future. It should be noted that both the liability to make lease payments and the liability to make payments for the separate acquisition of PPE or intangible assets are financial liabilities. Thus, this first issue is related to the definition of a financial liability.

22. Some think that all variable payments agreed in the purchase contract meet the initial recognition criteria of a financial liability and that they should therefore be initially included in the measurement of the liability to make lease payments (or the liability to make payments for the separate purchase of PPE and intangible assets). Proponents of this accounting point to the definition of a financial liability and the requirements in IAS 32 (paragraph 25) on contingent settlement provisions.

    > A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances)

> that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability).

23. Others think that variable payments that are dependent on the lessee's or purchaser's future activity do not meet the definition of a liability until the activity requiring the payment is performed. Proponents of this accounting think that these variable payments meet the definition of an executory contract and that the asset and the financial liability related to those variable payments should not be recognised until the activity requiring the payment is performed. They point to the guidance in IAS 39 (paragraph AG35) and in IAS 37 regarding executory contracts.

24. They also note that paragraph 25 of IAS 32 was the result of the incorporation of SIC-5 *Classification of Financial Instruments—Contingent Settlement Provisions* in 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 thus did not address the accounting for executory contracts).

25. Lastly, some also point to the definition of a liability in IAS 37 (paragraph 19). It is only those obligations arising from past events that exist independently of the purchaser's future actions (ie the future conduct of its business) that are recognised as liabilities. They think that variable payments that are dependent on the lessee's or 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 in IAS 37 until the corresponding activity is performed (ie until the sales are generated or the milestone is reached).

26. We note that this issue was discussed in detail in the Leases project. 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 payments and recognise this as a liability at lease commencement (these had been the proposals in the 2010 *Leases* exposure draft). However, after considerable feedback from constituents, 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.

27. We understand that the boards came to that conclusion for different reasons:

(a) Some IASB and FASB members are of the view that all variable lease payments meet the definition (ie the initial recognition criteria) of a financial liability. However, they were convinced 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 IASB and FASB members are of the view that, when the event requiring the payment is dependent on the lessee's future activity, the liability does not exist until the activity is performed.

28. We think that the reasons put forward by the boards in the Leases project to exclude particular variable payments from the initial measurement of the asset and liability are also valid within the context of the separate acquisition of PPE and intangible assets. As a result, we think that the Leases model is the most appropriate model for the accounting for variable payments that are dependent on the purchaser's future activity (such as in licence agreements or service concession arrangements for which payments are dependent on the purchaser's future revenues). In particular, this model takes into account the concerns expressed by constituents in the Leases project. See Example 3 in Appendix B.

Second issue: should the remeasurement of the liability be always recognised in P/L?

29. The second issue is whether the remeasurement of the liability should be recognised in P/L or should adjust the cost of the asset. An additional related question is whether an entity should adjust the cost of the asset indefinitely or whether adjustments to the cost should be prohibited after a specified period (as in IFRS 3 for contingent considerations paid in a business combination).

30. In order to deal with the variety of variable payments that exist, we think that changes in the measurement of the liability should not be always recognised in P/L. Changes in the measurement of the liability should be recognised as an adjustment to the cost of the asset to the extent that they relate to future periods (ie future economic benefits), as proposed in the Leases project.

31. For example, the cost of the asset purchased should be adjusted in the case in which variable payments are made if a milestone is reached (for example in a research and development project; see example 4 in Appendix B). Under the Leases model, those variable payments would not be included in the initial measurement of the asset and liability. If a milestone is reached at one stage of the research and development project, the acquirer is required to make additional payments. In example 4, those additional payments are related to the development of a new drug that is expected to generate future economic benefits. In our view, those payments should be capitalised in the cost of the intangible asset (the compound) in accordance with IAS 38 *Intangible Assets*.

32. We note that one of the concerns expressed by the Interpretations Committee regarding the Leases model is that the asset purchased would need to be adjusted at each reporting period and that this would create complexity. However, in the Leases model, we think that the asset would not need to be adjusted in most cases:

    (a) Fixed payments structured as variable in form that are initially included in the measurement of the asset and the liability can be reliably estimated and subsequent adjustment of the liability and the asset should not be required.

(b) Variable payments that are dependent on the purchaser's future activity are included in the measurement of the liability when they are incurred, ie when the corresponding activity requiring the payment is performed. Changes in the measurement of the liability are generally accounted for in P/L, because those changes are in most cases related to the current period (ie they are related to the activity performed in the current period; see Example 3 in Appendix B). As a result, in those cases, the asset does not need to be adjusted. In our view, the asset would be adjusted only in limited circumstances (see Example 4 in Appendix B).

33. The remaining question is whether the financial liability and the asset would need to be remeasured for variable payments that are dependent on an index or a rate. This issue is discussed below.

Third issue: should the remeasurement of a financial liability whose cash flows are linked to an index or a rate be recognised as an adjustment to the cost of the asset?

34. The issues are:

(a) whether a financial liability, accounted for at amortised cost in accordance with IAS 39, should be subsequently remeasured when that liability includes variable payments dependent on an index or a rate;

(b) and, if so, whether this remeasurement would be recognised as an adjustment to the cost of the asset in accordance with the proposed amendments described above.

35. These issues are related to the application of the effective interest method. Paragraphs AG6-AG8 of IAS 39 provide guidance on the application of the effective interest method. Floating rate financial instruments are accounted for in accordance with paragraph AG7. Other financial instruments (that are not considered to be floating rate financial instruments) are accounted for in accordance with paragraph AG8.

36. For variable payments that are dependent on a rate, it is clear that AG7 should be applied. For variable payments that are dependent on an index such as inflation or

CPI, it is not clear whether and how paragraph AG7 should be applied. The IFRIC (as it was then called) discussed this issue in an agenda decision published in IFRIC *Update* (July 2008). The IFRIC noted that judgement is required to determine whether an instrument is a floating rate instrument within the scope of paragraph AG7 or an instrument within the scope of paragraph AG8. The IFRIC referred the issue to the IASB with a recommendation that the IASB should consider clarifying or expanding that application guidance. The IASB has not yet addressed this issue but it should be discussed as part of the Impairment project.

37. If paragraph AG8 is applied, periodic re-estimation of cash flows to reflect movements in market rates of interest does not alter the effective interest rate. The carrying amount of the liability is adjusted to reflect actual and revised estimated cash flows, ie it is recalculated by computing the present value of estimated future cash flows at the original effective interest rate. According to paragraph AG8, this adjustment is currently recognised in P/L as a gain or loss. It would be presumably recognised as an adjustment to the cost of the asset if the Leases model were to be applied (and not in P/L).

38. If paragraph AG7 is applied, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. There are different methods in which the liability could be amortised in accordance with paragraph AG7. In one method, the finance cost in each period is based on a revised effective interest rate, calculated by discounting the expected cash flows to equal the carrying amount at the beginning of each period. In other words, if in subsequent periods there is a change in rate expectations, these changes are reflected by adjusting both the expected future cash flows and the effective interest rate. As a result, in that case, the carrying amount of the liability resulting from the application of AG7 does not need to be adjusted at the end of a reporting period (even if there is a change to the entity's expectations for the rate or index). The gain/loss is spread forward. It follows that the cost of the asset would not be adjusted in that case, because the remeasurement of the carrying amount of the liability (if any) relates entirely to a finance cost of the current period that is recognised in P/L.

39. We note that in practice entities make an accounting policy choice and apply either AG7 or AG8 to all similar instruments. See Example 2 in Appendix B.

Conclusion

40. We think that in order to deal with the variety of variable payments that exist and to answer the concerns expressed by constituents in the Leases project, the proposed model for the accounting for the separate purchase of PPE and intangible assets should meet the following objectives:

    (a) Variable payments that are dependent on the purchaser's future activity should be excluded from the initial measurement of the asset and liability. Many constituents in the Leases project indicated that including those variable payments in the initial measurement of the liability is complex and not sufficiently useful for users.

    (b) Changes in the measurement of the financial liability should not be always recognised in P/L, but should be recognised as an adjustment to the cost of the asset to the extent that those changes relate to future economic benefits to be derived from the asset.

    (c) For financial liabilities that include variable payments that are dependent on a floating rate (see discussions above on the notion of a floating rate), variations in the rate or the index should not trigger any adjustment to the carrying amount of the liability, or if there is an adjustment to the carrying amount of the liability, it should be recognised as an adjustment to the cost of the asset.

41. We think that the Leases model would meet those objectives as explained in detail above. The other models would not meet all of those objectives (see also Appendix C).

Amendments needed in the current literature in order to account for variable payments consistently with the requirements in the Leases project

42. We think that the accounting for variable payments for the separate acquisition of PPE and intangible assets should be aligned, to the extent possible, with the accounting for variable payments in the Leases project. As a result, we recommend the following amendments to the current IFRS literature.

Amendments to IAS 39:

43. We note that some board members are of the view that all variable payments meet the definition of a financial liability (ie all variable payments should be included in the initial measurement of the liability). As a result, if the objective is to align, to the extent possible, the accounting for variable payments for the separate acquisition of PPE and intangible assets with the accounting for variable payments in the Leases project, we recommend introducing a new paragraph in IAS 39 (either in the scope section of IAS 39, or in paragraph AG35 (b) relating to the initial recognition and firm commitments). There are two ways to draft the amendment:

    (a) **Alternative A (based on the wording used in the Leases project):** in Alternative A, the new paragraph would specify that IAS 39 does not apply to obligations arising from the separate acquisition of non-financial assets, except:

        (i) an obligation to make fixed payments (or in-substance fixed payments structured as variable in form); or

        (ii) an obligation to make variable payments that are dependent on an index or a rate.

    (b) **Alternative B (based on the requirements in IAS 37):** in Alternative B, the new paragraph would specify that IAS 39 does not apply to obligations arising from the separate acquisition of non-financial assets, except obligations to make variable payments that are dependent on the purchaser's future actions (such as the purchaser's future revenues to be derived from the use of the purchased asset). The result is that variable payments that are dependent on the purchaser's future activity would be recognised only when they are incurred, ie when the corresponding activity requiring the payment is performed.

44. We recommend amending IAS 39 based on Alternative B. Indeed, we think that the wording used in the Leases project was developed taking into account only the types of variable payments that are common in lease transactions. We do not think that the same wording would necessary work for all PPE and intangible asset purchase transactions. For example, suppose an entity agrees to make a payment if a piece of specialised manufacturing equipment reaches a standard production capacity once installed (see example 5 in Appendix B). We think that this payment should be included in the initial measurement of the asset and liability. If the scope exclusion is based on the wording used in the Leases project, we do not think that this payment would be included in the initial measurement of the asset and liability (unless the payment is considered to be an in-substance fixed payment structured as variable in form). We think that the wording proposed in Alternative B provides a better general principle based on the boards' decisions in the leases project and other relevant existing standards.

45. We also recommend amending IAS 39 (AG8) so that the remeasurement of a liability measured at amortised cost is recognised in P/L *unless IAS 16 or IAS 38 requires otherwise*. This would allow an entity to recognise changes in the measurement of a financial liability accounted for at amortised cost in accordance with AG8 of IAS 39 as an adjustment to the cost of an asset if IAS 16 or IAS 38 so requires.

46. It should be noted that the liability to make payments for the separate purchase of PPE or intangible assets would still be subsequently accounted for at amortised cost in accordance with IAS 39 in the proposed model. As a result, the proposed amendments would not be fully aligned with the Leases model. Indeed, in the Leases model, the boards tentatively decided to use spot rates (and not forward rates) for the estimation of cash flows that are dependent on an index or a rate and for the determination of the discount rate. In IAS 39, forecasting techniques (ie forward rates) should in principle be used.

47. It should also be noted that our objective is that the proposed amendments do not change the requirements regarding the accounting for derivatives that are embedded in financial liabilities. An entity would still need to determine whether derivatives embedded in financial liabilities are closely related and whether they should be recognised and measured separately in accordance with IAS 39.

Amendments to IAS 16 and IAS 38:

48. We recommend amending IAS 16 (paragraph 16) and IAS 38 (paragraph 27). There are two ways to draft the amendments:

    (a) **Alternative A (based on the wording used in the Leases project):** in Alternative A, we would specify that the purchase price (ie the cost of an asset) comprises fixed payments (including in-substance fixed payments structured as variable payments in form) and variable payments that are dependent on an index or a rate. All other variable payments would be excluded from the purchase price.

    (b) **Alternative B (based on the requirements in IAS 37):** in Alternative B, we would specify that the purchase price (ie the cost of an asset) comprises all the payments that the purchaser is obliged to pay for the acquisition of the asset, except variable payments that are dependent on the purchaser's future actions (such as the purchaser's future revenues to be derived from the use of the purchased asset).

    We recommend amending IAS 39 based on Alternative B (for the reasons presented in the section above).

49. We would also specify that the purchase price should be adjusted to reflect subsequent changes to the measurement of the liability to make payments to the extent that those changes relate to future economic benefits to be derived from the asset.

Accounting for variable payments for the separate acquisition of inventories

50. The question is whether we should also address the accounting for variable payments that are made for the separate acquisition of inventories. We do not think that there is a need to amend IAS 2 *Inventories* for the following reasons:

(a) We do not expect variable payments to be common in agreements for the purchase of inventories (but this should be confirmed through an outreach).

(b) We do not expect diversity in practice regarding the accounting for inventories. We expect entities to adjust the cost of inventories because variable payments for the separate purchase of inventories are generally made within one year after inception of the contract and are generally analysed as adjustments to the cost of inventories (as for discount received for the prompt settlement of invoices).

Questions to the Interpretations Committee	
1.	Does the Interpretations Committee think that the accounting for variable payments for the separate acquisition of PPE and intangible assets should be aligned, to the extent possible, with the accounting for variable payments in the Leases project?
2.	If so, does the Interpretations Committee agree in principle with the staff's proposals in the paper to amend IAS 16, IAS 38 and IAS 39?

Next steps

51. Assuming that the Interpretations Committee agrees that the accounting for variable payments for the separate acquisition of PPE and intangible assets should be aligned, to the extent possible, with the accounting for variable payments in the Leases project, we will send to the Interpretations Committee members for comment:

(a) the proposed amendments to IAS 39, IAS 16 and IAS 38; and

(b) the proposed amendments to IFRIC 12.

52. We would then present these proposals to the IASB. Assuming that the IASB agrees with those proposals, we would prepare an exposure draft to be published at the end of 2012.

Appendix A: Proposed requirements in the Leases project regarding the accounting for variable lease payments

A1. This section is based on the tentative decisions taken to date by the boards during the IASB meetings from February 2011 to July 2011.

Notion of variable lease payments

A2. In the Leases project, a variable lease payment refers to a lease payment that is not fixed. This variability can arise because of features based on:

(a) price changes, or changes in an external rate or the value of an index. In this type of lease, the amount of the lease payments is adjusted for changes in market lease rates, an external rate, such as LIBOR, or the value of an index, such as the consumer price index.

(b) the lessee's performance derived from the underlying asset. For example, a lease of retail property may specify that the lease payments are based on a specified percentage of sales made from that property.

(c) the usage of the underlying asset. For example, a car lease may require the lessee to make additional lease payments if the lessee exceeds a specified mileage.

Initial measurement of the lessee's liability

A3. The following variable payments would be included in the initial measurement of the lessee's liability to make lease payments (and in the initial measurement of the right-of-use asset):

(a) lease payments that are in-substance fixed lease payments but are structured as variable lease payments in form; and

(b) lease payments that depend on an index or a rate.

A4. All the other variable payments would be excluded from the measurement of the lessee's liability. These payments (such as lease payments based on future revenues derived from the use of the leased asset) would be recognised as an expense in P/L when they are incurred unless they relate to future periods.

A5. When initially measuring the liability to pay lease payments that depend on an index or a rate:

(a) the lessee would use the index or rate at the date of commencement of the lease (ie the spot rate) to determine the initial measurement of variable payments that depend on an index or a rate.

(b) the lessee would use the rate that the lessor charges the lessee to discount the lease payments that depend upon an index or a rate if that rate can be readily determined, otherwise the lessee would use its incremental borrowing rate.

Subsequent measurement of the lessee's liability

A6. A lessee would subsequently measure the liability at amortised cost.

Reassessment of the lessee's liability

A7. 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.

A8. Lessees would reflect changes in expected lease payments that depend on an index or a rate:

(a) in P/L 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.

A9. 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.

Reassessment of the discount rate

A10. A lessee would update the discount rate only when there is a change in lease payments 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.

Rationale underlying the decisions of the boards

A11. It should be noted that the August 2010 exposure draft proposed to recognise a liability and a right-of-use asset at the commencement of the lease term based on a probability-weighted estimate approach.

A12. Respondents commented that this approach was costly, especially for leases with a long lease term, and questioned the reliability of the estimates made for long leases. They indicated that accounting for variable payments on a probability-weighted or fair value basis at lease commencement would be extremely complex and would 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 to be derived from the use of the leased asset over a long lease term).

A13. The boards agreed that the cost of measuring all variable lease payments would not outweigh the benefit and therefore, the boards are proposing to include only those variable lease payments that are in substance fixed and those variable lease payments that are dependent on an index or a rate. The boards decided to include variable lease payments that are in substance fixed as these payments are unavoidable and hence give rise to assets and liabilities. The boards debated whether to leave this as a principle or provide further guidance. They felt that providing a principle was sufficient, rather than a list of possible scenarios, which would never capture every situation.

A14. We understand that the boards also decided to include variable lease payments dependant on an index or a rate because they are unavoidable payments that can be estimated with reasonable predictability. In other words, these variable payments meet the definition of a liability for the lessee and an asset for the lessor, it is just that the amount is somewhat uncertain.

A15. All other variable lease payments would be excluded from the lessee's liability (such as lease payments in a lease of retail property based on a specified percentage of sales made from that property). However, board members' views were split as to the reason why all other variable lease payments should be excluded. Some board members think that these other variable payments do not meet the definition of a liability until the future event requiring the payment occurs (eg a sale is made in the example above). Other board members think that they meet the definition of a liability but wanted to exclude them as a practical expedient, due to the level of cost and judgement that would be required to calculate these amounts, particularly for long-term leases.

Appendix B: Examples (application of the staff's proposals to the accounting for variable payments for the separate acquisition of PPE or intangible assets)

B1. We note that there are different types of variable payments for the separate acquisition of PPE and intangible assets. We have identified different types of variable payments:

(a) Variable payments that are in substance fixed payments (but structured as variable in form).

(b) Variable payments that are dependent on an index or a rate. The only variable is the index or the rate. In other words, the purchaser is certain to make the payments, but the amount of the payments are subject to a limited variability based on the evolution of an index. These variable payments are very common in licence agreements or service concession arrangements.

(c) Variable payments that are dependent on the purchaser's future revenues (or other measure of activity) derived from the use of the asset. These variable payments are also very common in licence agreements or service concession arrangements.

(d) Variable payments that are made if a milestone is reached (for example 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.

(e) Variable payments that are made if the asset acquired complies with agreed-upon specifications (such as a standard production capacity or a standard performance). These are payments that the purchaser generally expects to make at the inception of the contract. If the asset acquired has a defect and does not provide the expected performance, the payments are not made (ie the price to be paid for the asset is reduced).

B2. The objective of this section is to apply the staff's proposals to the accounting for variable payments in those various examples.

Example 1: payments that are fixed in substance but are structured as variable

B3. Entity A agrees to make a payment for land if it obtains approval from a local authority to build a structure on the land. The approval will be obtained, because the entity meets all the requirements in the regulation at the purchase date in order to obtain the approval and the local authority automatically grants the approval in that case.

B4. Initial accounting under the proposed model: The present value of the payment is initially included in the measurement of the asset and liability.

B5. Subsequent accounting under the proposed model: The liability is accounted for at amortised cost in accordance with IAS 39. The cost of the asset does not need to be adjusted.

Example 2: variable payments that depend on an index or a rate

B6. A 30-year service concession arrangement specifies that Operator B has a right to charge users for a public service in exchange for payments made to a grantor during the 30-year service concession period. Payments to the grantor are made at the end of each calendar year. At the inception of the contract on 1 January 2012, Operator B agrees to pay a concession fee of CU1000, with the amount increasing at the end of each year based on a CPI rate.

B7. Initial accounting under the proposed model: the present value of the variable payments is initially included in the measurement of the asset and liability in accordance with IAS 39. Forecasting techniques are in principle used to estimate the cash flows.

B8. Subsequent accounting under the proposed model: the liability is accounted for at amortised cost in accordance with IAS 39. If the CPI is analysed as a floating rate, the liability is amortised in accordance with paragraph AG7. If not, the liability is amortised in accordance with paragraph AG8. Adjustments to the carrying amount of the liability (if any) are recognised as an adjustment to the cost of the asset. See discussions above on the notion of floating rate financial instruments.

Example 3: variable payments that depend on revenues derived from the use of the asset

B9. A 30-year service concession arrangement specifies that Operator C has a right to charge users for a public service in exchange for payments made to a grantor. Payments are based on annual revenues generated though the sale of the public service to the users during the 30-year service concession period.

B10. Initial accounting under the proposed model: variable payments are not included in the initial measurement of the asset and liability.

B11. Subsequent accounting under the proposed model: Operator C recognises a liability when the corresponding revenues requiring the payments are generated. The debit entry of the liability is an expense, because the payments are related to the current reporting period (payments are related to the revenues generated in the current period). The liability is accounted for at amortised cost in accordance with IAS 39.

Example 4: variable payments that are made if a milestone is reached in a research and development project

B12. Entity D acquires a patent related to a new compound and agrees to make a first fixed payment at the date of acquisition. Entity D intends to use the compound in order to develop a new drug as part of a research and development project. Entity D has agreed to make variable payments to the vendor at different phases of the research and development project upon the achievement of specific milestones.

B13. Initial accounting under the proposed model: Entity D initially includes in the initial measurement of the asset and liability the present value of the first fixed payment to be made. Variable payments are not included in the initial measurement of the asset and liability.

B14. Subsequent accounting under the proposed model: Entity D subsequently includes in the measurement of the liability the present value of the variable payments when the corresponding milestones are reached. Changes in the measurement of the liability that are due to those variable payments 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).

Example 5: variable payments that are made if the asset complies with agreed-upon specifications

B15. Entity E agrees to make a fixed payment if a piece of specialised manufacturing equipment reaches a standard production capacity. The expectation at the purchase date is that the PPE will reach its standard production capacity 6 months after installation.

B16. Initial accounting under the proposed model: the present value of the fixed payment is initially included in the measurement of the asset and liability.

B17. Subsequent accounting under the proposed model: the liability is accounted for at amortised cost in accordance with IAS 39. Because the payments can be reliably estimated, the liability does not generally need to be remeasured and the asset does not need to be adjusted. However, if the PPE does not reach the standard production capacity, the liability is remeasured (ie reduced), and the cost of the asset should be reduced (to the extent that this reduction relates to a production capacity in future periods lower than expected).

Appendix C: Considerations regarding other models

Financial liability model and IFRS 3 model

C1. In a financial liability model or an IFRS 3 model, we note that all variable payments would be initially included in the measurement of the asset and liability. Furthermore, in a financial liability model, changes in the measurement of the liability would be recognised in P/L. Indeed, IAS 39 (AG8) specifies that the remeasurement of a financial liability accounted for at amortised cost should be recognised in P/L. In an IFRS 3 model, changes in the measurement of the liability would also be recognised in P/L for most of the changes. Indeed, in IFRS 3 (paragraphs 45 and 58):

(a) The measurement period does not exceed one year;

(b) Measurement period adjustments are adjustments made to reflect new information obtained about facts and circumstances that existed as of the acquisition date. As a result, changes resulting from events after the acquisition date, such as meeting an earning target or reaching a milestone on a research and development project are not measurement period adjustments.

C2. We think that these models are not appropriate for variable payments that are dependent on the lessee's or purchaser's future activity (such as variable payments that are dependent on revenues derived from the use of the asset or variable payments that are made if a milestone is reached in a research and development project). Indeed, we think that the reasons put forward by the boards in the Leases project not to apply those models are also valid in the context of the separate acquisition of PPE and intangible assets.

Expensed as incurred model

C3. We do not think that the expensed as incurred model is appropriate for variable payments that meet the definition of a liability in accordance with IAS 37. Indeed, we think that an asset and a liability should be initially recognised in those cases. As a result, we think that this model underestimates the entity's rights and obligations of the purchaser on day 1.