IFRS

STAFF PAPER

November 2015

IFRS Interpretations Committee Meeting

Project	**IAS 16 *Property, Plant and Equipment,* IAS 38 *Intangible Assets* and IFRIC 12 *Service Concession Arrangements***		
Paper topic	Initial recognition and measurement of variable payments for asset purchases		
CONTACT(S)	Jawaid Dossani	jdossani@ifrs.org	+44 (0)20 7332 2742

This paper has been prepared by the staff 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*.

Background and objective

1. The IFRS Interpretations Committee (the 'Interpretations Committee') received a request to address the accounting for contractual payments to be made by an operator under a service concession arrangement within the scope of IFRIC 12 *Service Concession Arrangements*. The Interpretations Committee noted that the issue of variable concession fees payable by an operator under a service concession arrangement is linked to the broader issue of accounting for variable payments for the purchase of property, plant and equipment and intangible assets outside of a business combination (hereafter referred to as 'variable payments for asset purchases').

2. The objective of this paper is to provide the Interpretations Committee with an analysis of the conceptual arguments underlying the leasing principles and their applicability to the initial recognition and measurement of variable payments for asset purchases. We have also analysed and presented the conceptual arguments underlying the principles in accounting for contingent consideration in business combinations (hereafter referred to as the 'business combination principles') and their applicability to accounting for variable payments for asset purchases.

Structure of the paper

3. This paper is organised as follows:

   (a) analysis of applying the leasing principles to the initial recognition and measurement of variable payments for asset purchases;

   (b) analysis of applying the business combination principles to the initial recognition and measurement of variable payments for asset purchases;

   (c) other considerations;

   (d) staff conclusion and recommendation;

   (e) questions for the Interpretations Committee;

   (f) Appendix A—summary of prior discussions; and

   (g) Appendix B—summary of feedback received on the 2010 and 2013 *Leases* Exposure Drafts

Applying the leasing principles to the initial recognition and measurement of variable payments for asset purchases

Summary of the implications of applying the leasing principles

4. The implications of applying the leasing principles to variable payments for asset purchases were explained in detail in Agenda Paper 06A of the Interpretations Committee meeting in September 2015.

5. If the principles developed in the Leases project were to be applied to the *initial accounting* for variable payments for asset purchases, we think that:

   (a) variable payments that are dependent on an index or a rate or are, in-substance fixed payments (but structured as variable payments), would be included in the initial measurement of the liability on the date of purchase of the asset. These payments would be measured using the index or rate at the date of purchase of the asset.

(b) other variable payments (such as those dependent on future activity of the purchaser) would not be included in the initial measurement of the liability on the date of purchase of the asset.

Rationale for principles on the initial recognition and measurement of variable consideration developed in the Leases project

6. The accounting for the obligation to make lease payments and, in particular, the accounting for variable lease payments was discussed in detail by the IASB in the Leases project.

7. The IASB initially proposed an approach that would have required an entity to estimate all variable lease payments and recognise this amount as a liability at lease commencement (these had been the proposals in the 2010 *Leases* ED (the '2010 ED')). This proposed approach has similarities with the accounting for contingent consideration in a business combination.

8. However, after considering the feedback received from respondents to the 2010 ED, the IASB decided to follow a different model and to exclude, from the initial measurement of the lease asset and liability, variable payments other than payments that are, in-substance fixed payments and payments that depend on an index or a rate. As a result, variable lease payments that are linked to future performance or use of the underlying asset in a lease are excluded from the initial measurement of the lease liability. A summary of the feedback received on the proposals of the 2010 ED and the 2013 *Leases* ED (the '2013 ED') has been reproduced in Appendix B of this paper.

9. However, we understand that the IASB members came to that conclusion for different reasons:

    (a) for some members, the decision about variable lease payments linked to future performance or use was made solely for cost-benefit reasons. Those members were of the view that all variable lease payments meet the definition of a liability for the lessee. However, they were persuaded by the feedback received from stakeholders that the costs of including variable lease payments linked to future performance or use would outweigh the

benefits, particularly because of the concerns expressed about the high level of measurement uncertainty that would result from including them and the high volume of leases held by some lessees.

(b) other members did not think that variable lease payments linked to future performance or use met the definition of a liability for the lessee until the performance or use occurs. They considered those payments to be avoidable by the lessee and, accordingly, concluded that the lessee does not have a present obligation to make those payments at the commencement date. 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 economic profits to be derived from the use of the asset.

10. For variable payments dependent on an index or a rate, the IASB decided that these payments meet the definition of liabilities for the lessee, because they are unavoidable (ie a lessee has a present obligation to make those lease payments) and do not depend on any future activity of the lessee. Any uncertainty, therefore, relates to the measurement of the liability that arises from those payments and not to the existence of that liability.

11. For variable lease payments that depend on an index or a rate, the IASB decided to require an entity to determine payments at initial recognition that depend on an index or a rate using the index or rate at the commencement date. In the IASB's view, forecasting techniques could be used to determine the effect of changes in an index or a rate on the measurement of lease liabilities. However, forecasting changes in an index or a rate requires macroeconomic information that may not be readily available to entities, and may result in measurement uncertainty. The IASB noted that the usefulness of the enhanced information obtained using such a forecast may not often justify the costs of obtaining it, particularly for those lessees with a high volume of leases. The IASB considered requiring a lessee to use forward rates when measuring lease liabilities if they are readily available. However, it decided not to do so because this would reduce comparability between those using forward rates and those not.

Applicability of the rationale to variable payments in asset purchase transactions

12. We think that there are similarities between a lease transaction and an asset purchase transaction. This is because:

    (a) the IASB noted that when an asset (the underlying asset) is made available for use to a lessee, the lessee obtains an asset—the right-of-use asset. If lease payments for that right-of-use asset are made over time, the lessee also incurs an obligation to make lease payments for that right. Similarly, the purchaser in an asset purchase transaction obtains an asset (a physical or an intangible asset). If payments for the asset are made over time, the purchaser also incurs an obligation to make payments.

    (b) during the redeliberations of the 2010 and 2013 EDs, the IASB noted that most users of financial statements consulted thought that leases create assets and 'debt-like' liabilities for a lessee. Similarly, in cases in which the payments for purchases of assets are to be made over time, we think that the vendors of the assets effectively provided financing to the purchasers and this creates a 'debt-like' liability for the purchaser.

    (c) IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* require an asset to be measured initially using a cost-based approach. Similarly, the IASB has concluded that a lessee should measure a right-of-use asset arising from a lease contract using a cost-based approach.

    (d) IAS 17 *Leases*, which is the currently effective Standard on leases, requires a finance lease (which is a lease that transfers substantially all the risks and rewards of ownership) to be accounted for by a lessee in a manner similar to that of an asset purchase, which implies that the two transactions, although different in legal form, are economically similar in substance.

13. We note that in developing the leasing principles, the IASB did not conclude on whether variable payments linked to future performance or use of the underlying asset in a lease meet the definition of a liability. Similarly, in its discussions on variable payments for asset purchases, the Interpretations Committee could not reach a consensus on whether variable payments that depend on purchaser's future

activity should be excluded from the initial measurement of the liability until the activity is performed.

14. Some members were of the view that all variable payments meet the initial recognition criteria of a financial liability. These members took the view that among other things, the purchaser's agreement to make payments is the obligating event and the contract is not executory if the asset has already been delivered to the purchaser. This is because the seller has no further obligation to perform.

15. Other members were of the view that variable payments that are dependent on the purchaser's future activity do not meet the definition of a liability. They thought that, among other things, arrangements in which the variable payments are linked to future activity are a means through which the purchaser and seller can share risks and profits to be derived from the use of the asset after the asset has been delivered. The variable payment arrangement is seen as a form of arrangement that is distinct from the initial purchase of the asset.

16. A more comprehensive summary of the previous discussions of the Interpretations Committee and the alternative views considered have been reproduced in Appendix A.

17. We have assessed later in this paper whether the proposals in the Exposure Draft *Conceptual Framework for Financial Reporting* (hereafter referred to as the '*Conceptual Framework* Exposure Draft') may help the Interpretations Committee reach a consensus on whether these payments represent a liability. This analysis is presented in paragraphs 31–43 of this paper. We think that while the proposals in the *Conceptual Framework* Exposure Draft provide some additional clarity, they do not provide a definitive answer that would direct the Interpretations Committee to a conclusion on whether variable payments that depend on the purchaser's activity meet the definition of a liability.

18. A key consideration in developing the leasing principles for variable payments was the cost-benefit analysis on applying any proposed solution. As noted in paragraph 9(a), members of the IASB who thought that variable lease payments linked to future performance or use meet the definition of a liability were persuaded that the costs of requiring an entity to include those payments in the

lease liability would outweigh the benefits, particularly because of the concerns expressed about the high level of measurement uncertainty that would result from including them and the high volume of leases held by some lessees. In addition, the cost-benefit analysis was also a key factor that led the IASB to decide that variable payments in lease contracts that were based on an index or a rate should be measured using the index or rate at commencement date (as opposed to a forward-looking rate).

19. Appendix B of this paper provides a summary of the feedback received on the 2010 and the 2013 EDs. We think the cost-benefit considerations that are applicable to the accounting for variable payments for lease contracts also apply to the accounting for variable payments for asset purchases, because of the similarities between asset purchases and lease contracts.

20. Respondents to the 2010 and 2013 EDs commented on the volume of leases that some entities have and the onerous burdens that the original proposals (ie requiring an entity to include an estimate of all variable payments at initial recognition) would have placed on those entities. Based on prior experience and outreach, we think that there are fewer entities with an extensive number of asset purchase contracts containing variable payment clauses. However, we acknowledge that there could still be some entities with several asset purchase contracts with variable payment clauses.

21. In particular, we note that requiring an entity to record variable payments based on the purchaser's future activity, or requiring an entity to use forward looking estimates to record variable payments based on an index or a rate, could:

(a) be costly, challenging and complex to reliably estimate;

(b) create significant volatility in profit or loss; and

(c) reduce the usefulness of information provided to users due to the level of measurement uncertainty inherent in the estimate.

22. Obligations under a lease contract are accounted for under the Standard applicable to lease contracts. If the leasing principles are applied to variable payments for asset purchases, we think that some aspects of recognition and measurement of

these variable payments will have to be excluded from the scope of IFRS 9 and additional guidance will need to be included in IAS 16 and IAS 38.

Advantages and disadvantages of adopting the leasing principles

23. Our views on the advantages and disadvantages of adopting the leasing principles are summarised in the following table:

Advantages	**Disadvantages**
• May better reflect the fact that variable lease payments based the on usage or performance provides an entity with flexibility and shares their business risk with the seller. • Avoids problems with measurement uncertainty that could reduce the usefulness of information being provided to the users of the financial statements. • Creates consistency with accounting for lease contracts, which reduces opportunities to structure a contract as a lease or a purchase in order to obtain a more favourable accounting outcome. • Principles are straightforward to understand and apply and will not create significant costs for entities.	• May understate the entity's obligation because it could exclude cash flows that could be highly likely or for which the entity has little realistic possibility of avoiding. • Differences with the accounting for contingent consideration in a business combination results in additional pressure on applying the definition of a business. • Could lead to opportunities to structure certain financing contracts as variable payment purchase contracts in order to achieve a desired accounting outcome. However, we think that this will generally not be applicable for financing contracts with third parties and will only be limited to some vendor take-back financing arrangements.

Applying the business combination principles to variable payments for asset purchases

Summary of the implications of applying the business combination principles

24. If the business combination principles were to be applied to the initial accounting for variable payments for asset purchases, we think that the purchase-date fair value of all variable payments (whether based on indices, rates or the purchaser's future activity) would be recognised as part of the consideration transferred in exchange for the asset.

Rationale for business combination principles

25. According to paragraphs BC346–BC349 of IFRS 3 *Business Combinations*, the IASB considered that:

    (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 exchanged at that date.

    (d) measuring the fair value of some contingent payments may be difficult, but to delay the 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.

    (e) a contingent consideration arrangement is inherently part of the economic considerations in the negotiations between the buyer and the seller. Such arrangements are commonly used by buyers and sellers to reach an agreement by sharing particular specified economic risks related to uncertainties about future outcomes. Differences in the views of the buyer and seller about those uncertainties are often reconciled by their agreeing to share the risks in ways by which favourable future outcomes generally

result in additional payments to the seller and unfavourable outcomes result in no or lower payments. The IASB observed that information used in those negotiations will often be helpful in estimating the fair value of the contingent obligation assumed by the acquirer.

(f) most contingent consideration obligations are financial instruments, and reporting entities that use such instruments extensively, auditors and valuation professionals that are familiar with the use of the valuation techniques for estimating the fair values of financial instruments. The IASB concluded that acquirers should be able to use valuation techniques to develop estimates of the fair values of contingent consideration obligations that are sufficiently reliable for recognition.

Applicability of the rationale to variable payments in asset purchase transactions

26. Conceptually the purchase of an individual asset could be considered as being similar to a transaction in which an entity acquires a business. The acquirer or the purchaser obtains control over the asset or business generally in exchange for consideration. The only difference is that a business is an integrated set of activities that is capable of being conducted and managed for the purposes of providing a return while a single asset does not represent a similar integrated set of activities.

27. The IASB recently completed its Post-implementation Review of IFRS 3. In the request for information, the IASB asked stakeholders if there were any benefits of having separate accounting treatments for business combinations and asset acquisitions. One of the messages received from constituents was that a separate accounting treatment for business combinations and asset acquisitions is conceptually justified only with respect to whether or not goodwill is recognised. Constituents suggested that the IASB should revisit whether the differences in the accounting treatment for deferred tax, contingent payments and acquisition costs are really justified, taking into consideration the difficulties that arise from having to determine whether a transaction represents an acquisition of assets or a business combination.

28. The rationale applied by the IASB in developing the business combination principles, which is outlined in paragraph 25, also applies to variable payments for asset purchases. Similarly, we think that variable payments for asset purchases are inherently part of the economic considerations in the negotiations between the buyer and the seller. Such arrangements are commonly used by buyers and sellers to reach an agreement by sharing particular specified economic risks related to uncertainties about future outcomes. Differences in the views of the buyer and seller about those uncertainties are often reconciled by their agreeing to share the risks in ways by which favourable future outcomes generally result in additional payments to the seller and unfavourable outcomes result in no or lower payments.

29. IFRS 3 generally uses a fair value model to account for the acquisition of a business and requires the consideration transferred to be measured at fair value. IAS 16 and IAS 38 use a cost based model, but similar to IFRS 3 require the consideration transferred to be measured at fair value. Paragraph 6 of IAS 16 and paragraph 8 of IAS 38 define cost as (emphasis added):

> the amount of cash or cash equivalents paid or the *fair value* of other consideration given to acquire an asset at the time of its acquisition or construction …

Advantages and disadvantages of adopting the business combination principles

30. Our views on the advantages and disadvantages of adopting the business combination principles are summarised in the following table:

Advantages	**Disadvantages**
• May provide a more faithful depiction of the purchaser's obligation and the vendor's receivable. • Reflects the fair value of management's estimates of the cash inflows/outflows from the entire transaction.	• Would include estimates of variable lease payments that may be highly subjective and uncertain. Significant uncertainty in the measurement of the variable payment could diminish the usefulness of the information. • Could lead to opportunities for

Advantages	Disadvantages
• Consistency in accounting for variable payments in asset purchases and business combinations reduces the pressure on applying the definition of a business and alleviates a key concern noted by many constituents during the Post-implementation Review of IFRS 3.	structuring asset purchase contracts as leases in order to obtain a more favourable accounting treatment for variable payments. • May be difficult and complex to apply.

Other considerations

Do the principles in the Conceptual Framework *Exposure Draft provide a basis for determining the appropriate accounting for variable payments for asset purchases?*

31. The Interpretations Committee could not previously reach consensus on whether variable payments that were dependent on the purchaser's future activity met the definition of a liability. Since the Interpretations Committee's previous discussions on this issue, the IASB has published the *Conceptual Framework* Exposure Draft in May 2015.

32. The Introduction to the *Conceptual Framework* Exposure Draft notes that the *Conceptual Framework* is not a Standard and does not override specific Standards. The proposals are intended to provide a more complete, clear and updated set of concepts that will help the IASB to develop Standards that better meet the needs of investors, creditors and other lenders.

33. The *Conceptual Framework* Exposure Draft proposes to provide additional guidance to support the definition of a liability. Among the proposals are concepts to help determine whether a 'present' obligation exists if the eventual need to transfer economic resources depends on an entity's future actions. Paragraph 4.31 of the *Conceptual Framework* Exposure Draft proposes that two conditions must be met for a present obligation to transfer an economic resource to exist:

(a) the entity has no practical ability to avoid the transfer; and

(b) the obligation has arisen from past events; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.

34. We have considered both these conditions to help determine whether an agreement to make a variable payment for an asset purchase meets the proposed definition of a liability on the date of purchase of the asset.

Does an entity have the practical ability to avoid making a variable payment for an asset purchase?

35. Paragraph 4.35 of the *Conceptual Framework* Exposure Draft notes that:

> … in some situations, the requirement for an entity to transfer an economic resource may be expressed as being conditional on a particular future action by the entity, such as conducting particular activities or exercising particular options within a contract. The entity has an obligation if it has no practical ability to avoid that action.

36. Paragraph 4.32 of the *Conceptual Framework* Exposure Draft states that (emphasis added):

> An entity has no practical ability to avoid a transfer if, for example, the transfer is legally enforceable, or any action necessary to avoid the transfer would cause *significant business disruption* or would have *economic consequences significantly more adverse than the transfer itself*. It is not sufficient that the management of the entity intends to make the transfer or that the transfer is probable.

37. Asset purchase transactions normally represent exchange transactions between knowledgeable and willing counterparties. It is generally in the purchaser's best interest to undertake the future activity on which the variable payment is based (for example, generate sales through the use of the asset). Avoiding this action would generally lead to more serious adverse consequences than making the actual variable payment itself. We therefore think that in most cases, on the date of

purchase of an asset, a purchaser could be assumed to have no practical ability to avoid making the variable payments.

Does an entity have a present obligation for variable payments for an asset purchase?

38. Paragraph 4.36 of the *Conceptual Framework* Exposure Draft states (emphasis added):

> An entity has a present obligation as a result of a past event only if it has *already received the economic benefits, or conducted the activities*, that establish the extent of its obligation. The economic benefits received could include, for example, goods or services. The activities conducted could include, for example, operating in a particular market. If the economic benefits are received, or the activities are conducted, over time, a present obligation will accumulate over time (if, throughout that time, the entity has no practical ability to avoid the transfer).

39. Paragraph 4.39 of the *Conceptual Framework* Exposure Draft states:

> An entity does not have a present obligation for the costs that will arise if it will receive benefits, or conduct activities, in the future (for example, the costs of future operations); the extent of the future transfer will not be determined by reference to benefits that the entity has received, or activities that it has conducted, in the past. If the entity has entered into a contract that is *still executory*, the entity may have a present right and obligation to exchange economic resources in the future.

40. We think that in applying the proposals in the Conceptual Framework Exposure Draft, it would be possible to reach two different views on whether a purchaser has received the benefits or conducted the activities that establish the extent of its obligation to make variable payments. On one hand, it could be argued that the entity has received the asset and, therefore, has received the economic benefits. On the other hand, it could be argued that the entity has not performed the activity or

received the benefit that establishes the extent of the variable payments, and hence the extent of its obligation on the date of purchase of the asset.

41. Further, paragraph 4.40 of the *Conceptual Framework* Exposure Draft defines an executory contract and notes that:

> An executory contract is a contract that is equally unperformed: neither party has fulfilled any of its obligations, nor both parties have fulfilled their obligations partially and to an equal extent.

42. Variable payments for asset purchases that are dependent on the purchaser's future activity are seen as a means by which the vendor and the purchaser can share future profits to be derived from the use of the asset. We think that the arguments that were considered previously by the Interpretations Committee on whether or not such arrangements represent executory contracts (see paragraphs A14–A17) continue to apply under the proposed new *Conceptual Framework*.

43. We think that while the proposals in the *Conceptual Framework* Exposure Draft provide some additional clarity, they do not provide a definitive answer that would direct the Interpretations Committee to a conclusion on whether variable payments that depend on the purchaser's activity meet the definition of a liability.

Should the Interpretations Committee consider another model for developing principles for the initial recognition and measurement of variable payments for asset purchases?

44. We note that applying the business combination principles results in recognition and measurement of all variable payments upon acquisition of the asset, whereas applying the leasing principles results in the exclusion of some variable payments from initial recognition and measurement of the liability.

45. We considered whether there was an alternative approach that could be considered by the Interpretations Committee for developing principles for the initial accounting for variable payments.

46. One approach that has been considered by the IASB in the past when developing the leasing principles is the inclusion of all payments with a high probability threshold within the initial recognition and/or measurement of the liability.

47. This approach has similarities with the principles applied by a vendor in a revenue transaction. The guidance on variable consideration in IFRS 15 *Revenue from Contracts with Customers* requires an entity to:

    (a) estimate the amount of variable consideration in a contract; and

    (b) include in the transaction price those variable payments for which it is highly probable that a significant reversal of the amount recognised will not occur when the uncertainty is subsequently resolved.

48. We do not think that requiring a purchaser to apply an approach based on the probability of making the variable payments will necessarily result in symmetrical accounting outcomes with the vendor. This is because the judgement applied by the purchaser and the vendor may result in different conclusions as to the probability of the cash flows resulting from the arrangement, which could in turn result in a non-symmetrical accounting treatment by the two parties for the same payment. The vendor may have significant experience from similar transactions that it could consider in making its assessment. Asset purchases maybe more likely to be one-off transactions for purchasers, as a result of which they may not have the benefit of similar experience in making the assessment.

49. We also note that while this approach was considered by the IASB in developing the leasing principles, it was not adopted by the IASB for accounting for variable payments in a lease contract. We understand that a majority of users and preparers did not favour this approach and noted that the costs would outweigh the benefits.

50. Our views on the advantages and disadvantages of applying an approach requiring inclusion of payments based on a high probability threshold are summarised in the following table:

Advantages	Disadvantages
• May give a more faithful depiction of the obligations incurred by the purchaser than the leasing principles, because it may be more reflective of the expected cash flows. • Because measurement is less subjective when compared to applying the business combination principles, both the balance sheet and the profit/loss statement could result in the presentation of more reliable estimates. • May be more straightforward to apply than the business combination principles because lower probability payments are excluded.	• Judgement of probability may be highly subjective and could vary between entities for economically similar contracts. This would reduce the comparability and consistency of financial information reported. • Could lead to opportunities for structuring contracts as leases, not purchases, in order to obtain a more favourable accounting treatment. • Difference with the accounting for contingent consideration in a business combination does not result in alleviating the pressure on applying the definition of a business. • As compared to applying the business combination principles, this approach could result in a liability that is less reflective of the lessee's contractual obligations to make payments. • May be more difficult, complex and costly to apply as compared to the leasing principles.

51. We think the disadvantages of this approach outweigh the advantages and do not recommend applying these principles in developing the principles for initial accounting for variable payments in an asset purchase.

Staff conclusion and recommendation

52. In developing IFRS 3, the IASB took the view that contingent consideration in a business combination represented an unconditional obligation of the purchaser and the obligating event was the purchaser's agreement to make the contingent payments. Nevertheless, when developing the leasing principles, the IASB did not

conclude on whether variable payments linked to future performance or use of the underlying asset in a lease that meets the definition of a liability.

53. We recommend applying the business combination principles to the initial accounting for variable payments for asset purchases. We think that applying the business combination principles provides a more conceptually robust solution and leads to a more faithful representation of the economic consideration exchanged between the parties at the date of purchase of the asset.

54. We acknowledge the concerns of constituents who note that the costs of applying the business combination principles are significant, but on balance we think that the advantages of this approach, as discussed previously, outweigh the costs and disadvantages. We note in particular that applying the business combination principles will reduce the pressure on the distinction between an asset and a business, which was one of the concerns noted by constituents in the Post-implementation Review of IFRS 3.

55. If the Interpretations Committee agrees with our analysis and recommendation, we think that the Interpretations Committee should consult the IASB to obtain its views on the Interpretations Committee's tentative decision prior to the Interpretations Committee developing proposals for amendments to the Standards to reflect its decisions. This is because of the recent discussions of the IASB on variable payments in its projects on revenue recognition and leases.

56. If the Interpretations Committee cannot reach a consensus on the initial accounting for variable payments for asset purchases and thinks that the issue is not sufficiently narrow in scope for it to be able to address in an efficient manner, we think that it should consider recommending a project to the IASB. The IASB could then consider whether or not to add the project to its work plan on the basis of the feedback from the Interpretations Committee and the feedback it will receive from constituents as part of the Agenda Consultation. The Interpretations Committee can continue its work on the related issue of payments made by an operator to a grantor in a service concession arrangement. We think that it may be possible to effectively develop a solution for this issue within the confines of IFRIC 12 without the need to address the broader issue of variable payments for asset purchases. This is discussed in more detail in Agenda Paper 02C.

Questions to the Interpretations Committee

1. Does the Interpretations Committee agree with our analysis and recommendation that the business combination principles should be applied in developing principles for the initial accounting for variable payments in an asset purchase?
2. If the Interpretations Committee agrees with our analysis and recommendation to apply the business combination principles, does it agree with our recommendation to consult the IASB prior to developing proposed amendments to the Standards to reflect its conclusions?
3. If the Interpretations Committee does not agree with our conclusion and recommendation to apply the business combination principles, what other approach does it Committee think it should apply?
4. If the Interpretations Committee cannot reach a consensus on the initial accounting for variable payments for asset purchases, does it agree with the staff conclusion that the project should be referred to the IASB and the Interpretations Committee should continue to work on resolving the accounting for payments to be made by an operator to a grantor in a service concession arrangement?

Appendix A
Prior discussions[1]

Summary of prior discussion and tentative decisions on initial accounting for variable payments for asset purchases

A1. The Interpretations Committee observed that the obligation to make 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 *Financial Instruments: Presentation*/IAS 39 *Financial Instruments: Recognition and Measurement*/IFRS 9 *Financial Instruments*.

A2. 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.

A3. 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).

A4. 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; and

[1] Excerpts of Agenda Paper 06A of the Interpretations Committee meeting in September 2015.

(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.

A5. 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 when 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 in the following sections.

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

A6. 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.

A7. 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.

A8. 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).

A9. 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.

A10. 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

A11. 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.

A12. 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.

A13. Proponents of Alternative 2 note that paragraph 25 of IAS 32 (see Alternative 1) 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.

A14. Lastly, proponents of Alternative 2 point to the guidance in IAS 39 regarding executory contracts (paragraphs 5, AG35(b) and the 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.

A15. 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).

A16. 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.

A17. 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 property, plant and equipment 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.

Appendix B
Summary of feedback received on proposals for variable payments in the 2010 and 2013 *Leases* EDs

B1. The following presents a summary of the feedback received on the proposals for accounting for variable payments in the 2010 and 2013 *Leases* Exposure Drafts.

Summary of feedback received on the 2010 ED[2]

Summary of user feedback

B2. Users had mixed views on the treatment of variable lease payments. Under current leases guidance, there is little information about variable lease payments. Therefore, users welcome better access to information about these payments, but have conflicting views on how best to provide it.

B3. Users supported obtaining additional information relating to variable lease payments but were mixed in their views on whether amounts recognised in the financial statements should reflect:

(a) only contractual fixed minimum lease payments (allowing users to apply their own judgment to estimate variable lease payments, based on disclosures);

(b) in-substance contractual lease payments (similar to the alternative view expressed in the 2010 ED); or

(c) all payments under the lease arrangement, including variable payments as proposed in the 2010 ED (noting that management estimates could be adjusted by users to meet their specific needs based on information disclosed in the notes).

B4. Some users think that estimates are a part of business and that including variable lease payments in the measurement of an entity's leased assets and liabilities, similar to other accounting estimates, provides the best possible information in the statement of financial position about that entity's assets and liabilities as long as users can understand the assumptions behind the estimates through appropriate disclosures.

[2] This summary has been extracted from Agenda Paper 5A of the February 2011 meeting of the IASB.

Those users argue that users place different weight on information that is included in the statement of financial position compared with information that is only disclosed:

> Exclusions of these amounts could result in significant understatement of the economic assets and liabilities under leases. Therefore, we believe measuring them initially is preferable to excluding them from the calculation of estimated lease payments and then recognising the expense when incurred, as is generally the case under existing standards. (CL #748)

B5. Users also cited the difference in timeliness of information provided in the financial statements and in the notes. They observed that information presented in the financial statements is usually available earlier (typically in an earnings release) than information included in footnote disclosures.

B6. Other users prefer to see only the minimum contractual fixed lease payments on the statement of financial position and additional, detailed information disclosed about variable lease payments in the footnotes, because of the uncertainly in estimating such amounts:

> Generally we prefer balance sheet assets and liabilities to be as “real” as possible otherwise they start to become less useful …
>
> On balance, we are nervous about requiring companies to estimate and capitalise contingent lease payments such as revenue-based payments. These contingent liabilities are really future operating expenses as the amount and timing will depend on how the business performs. From a fundamental standpoint, it is difficult to see why contingent lease payments should be capitalised when other contingent costs such as cost of goods, wages and so on are not. It would also be both onerous and subjective for preparers to estimate multi-year future contingent liabilities.
>
> As users, we also ask ourselves what we would do with this information. While it would be interesting to see more information about options and contingencies, we do not see

> that the utility of the balance sheet would be improved by including these very subjective items as concrete liabilities. We recognise that requiring lessees to capitalise only contractual liabilities may create opportunities for structuring but this is preferable to having a potentially meaningless (and also much larger) asset and liability. (CL #675)

B7. Some users did not think that performance-based and usage-based contingencies should be considered in the measurement of the lease liability, but think that only index-based contingencies should be considered.

Summary of comment letter feedback

B8. Many respondents to the 2010 ED (which included preparers, users, industry organisations, etc) expressed concerns relating to the proposals for including variable lease payments that depend on future performance or usage in the measurement of a lessee's liability to make lease payments and the lessor's lease receivable. Those respondents commented that:

(a) performance-related payments are economically structured to provide a sharing of future risks between the lessee and lessor (for example, in the retail industry, leases for store space in a mall may involve a minimum lease payment plus a payment based on future sales to incentivise the performance of the mall owner (lessor)).

(b) a mismatch could arise between income and expenses. For example, if a retailer has lease payments that are contingent on sales, the lease payments are often viewed similarly to a commission and, therefore, should be recognised consistently with the underlying sales.

(c) contingent payments based on usage are akin to renewal options.

(d) recognition of revenue by lessors for these lease payments would be inconsistent with the *Revenue Recognition* ED.

B9. In addition, many respondents to the 2010 ED disagreed with the proposal to estimate variable lease payments using an expected outcome technique. These respondents commented that estimating variable lease payments would:

(a) be costly and challenging to reliably estimate; and

(b) create significant volatility in profit or loss.

B10. Many respondents suggested alternative approaches such as:

(a) the approach proposed in the alternative view of the 2010 ED, which advocates including only variable lease payments based on indices or rates and excluding variable lease payments that vary with usage or performance (noting that similar guidance in current US GAAP works well in practice);

(b) including only those variable lease payments that are outside of an lessee's control and are therefore unavoidable; or

(c) changing the estimation approach from 'expected value' to an alternative estimation technique (ie to be consistent with the threshold for recognising options to renew or cancel leases).

B11. The comment letter feedback received from private companies was consistent with that of the overall feedback from other comment letters summarised in this memo. However, private companies noted that, with many accounting departments consisting of only a few members, the proposal may be even more burdensome than for a larger public company:

> We agree conceptually with the proposed treatment of contingent rental payments and payments from residual value guarantees for lessees. However, we believe it is likely lessees will encounter significant operationality issues in making some of the required estimates. For example, we believe lessees will struggle to estimate contingent rents that are based on future sales related to assets under long-term leases as the lease term will in all likelihood extend well beyond the normal budgeting and planning periods. We believe this to be an area in which the FASB should carefully weigh the costs to comply with the standard with the benefits received by users of the financial statements (CL #66)

Summary of feedback received on the 2013 ED[3]

B12. Most constituents, including most users, agree with the changes made to the 2010 ED proposals about the accounting for variable lease payments. Constituents generally said that variable payments contingent on future events (for example, performance or use) do not represent a present obligation of the lessee nor a right of the lessor and, therefore, do not meet the definition of an asset or a liability. These constituents agree that an entity should recognise variable lease payments (that do not depend on an index or a rate) in profit or loss in the period incurred (or earned). In addition, many constituents, including most users, said that they would not want subjective estimates about variable lease payments reflected in the measurement of lease assets and lease liabilities.

B13. A representative quote from the comment letters is as follows:

> In our view the proposals on initial measurement of variable lease payments are a pragmatic solution to a difficult issue. We recognise that as a result of those proposals the actual lease payments a lessee is obligated to make may exceed the estimated lease payments used in measuring assets and liabilities of the lessee and lessor. However, the proposals demonstrate the sharing of risk between a lessee and lessor that is reflected in variable lease payments. In addition, there are many lease arrangements (e.g. leases of retail space with rentals that are a percentage of the lessee's sales, sometimes with lease payments that are entirely contingent on sales) in which there is significant uncertainty about the timing and amount of variable lease payments. We believe that uncertainty increases the potential complexity and cost of estimating variable lease payments while reducing the potential benefits of such estimates. We agree that disclosure of the basis, terms and conditions on which variable lease payments are determined is a more appropriate alternative than recognition and measurement of such payments. (CL 199 – *Accounting Firm*)

[3] This summary has been extracted from Agenda Paper 3B of the April 2014 meeting of the IASB.

B14. Conversely, some constituents request that the Boards revert to the proposals for variable lease payments in the 2010 ED. These constituents think that:

(a) it is the *measurement* of future variable lease payments that is uncertain, not the *existence* of the asset or the liability. Some note that the measurement of variable lease payments is no more difficult than, for example, determining the fair value of in-process research and development in a business combination. Excluding those payments could result in a significant understatement of a lessee's liability and a lessor's receivable.

(b) estimates are inherent in lease accounting, such as the proposals for residual value guarantees. Accordingly, an entity should treat variable lease payments that do not depend on an index or a rate in the same way as other lease payments (that is, include estimates of such payments in the measurement of the lease asset and lease liability).

(c) lessees entering into leases with variable payments must have some reliable estimate of their expected lease payments; otherwise, they would not enter into such leases.

B15. A representative quote from the comment letters is as follows:

> We do not support with the exclusion of variable payments linked to sales or use as proposed in the Revised ED. This approach is inconsistent with the recognition threshold for other standards related to liability recognition. It is also not clear whether this approach is consistent with the revenue recognition approach in the recognition and measurement of contingent and variable revenue.
>
> It is important that there is separate disclosure of the variable lease payments, regardless of whether these are included in the measurement of the lease obligation. (CL 620 – *Large User Group*)

B16. Many constituents conceptually support the inclusion of variable lease payments that depend on an index or a rate as proposed in the 2013 ED. These constituents said that it is appropriate to include such payments in the initial measurement of the lease

assets and lease liabilities, because the lessee has no ability to avoid variable payments that depend on an index or a rate.

B17. However, some constituents think that the proposals may reduce comparability between entities if the terms and conditions of their leases differ, but the economics of those leases are similar. Under the 2013 ED, a lessee with a lease with only variable lease payments (that do not depend on an index or a rate) would not be required to recognise a lease asset and a lease liability (even if the lessee expects to make lease payments of, for example, CU100 in each period).[4] In contrast, a lessee with a similar lease with fixed lease payments of CU100 in each period would be required to recognise a lease asset and a lease liability. These constituents did not think that the accounting proposed in the 2013 ED would properly reflect what they view as economically similar leases.

B18. With regards to the reassessment of variable lease payments that depend on an index or a rate, some constituents support the reassessment proposals, including some users and a few preparers. However, almost all constituents expressed concerns about the reassessment proposals for variable lease payments from a cost and complexity perspective. Many added that they would not expect the proposed reassessment requirements to affect the income statement in any meaningful way. Consequently, they think that the cost of applying the reassessment proposals would outweigh any benefit.

B19. A representative quote from the comment letters is as follows:

> Under the proposed guidance, lessees will record all leases on balance sheet, and must reassess the economic incentives associated with lease term extensions or lease termination options and rates used to record variable rents each reporting period, and re-measure the recorded lease asset and liability whenever there is a change, which for public companies could be as frequently as quarterly. This assessment and adjustment process, which must be performed at the individual leased asset level, will be unnecessarily burdensome and costly to implement and maintain. … Consistent with current

[4] In this paper, monetary amounts are denominated in 'currency units' (CU).

accounting for contingent rents, changes in variable lease payments should be recorded in the period of change without re-measurement of the lease asset and liability. (CL 95 – *Large Preparer*)

B20. A number of fieldwork participants also emphasised the costs and complexity associated with the reassessment of variable lease payments based on an index or a rate. In particular, one fieldwork participant noted that it has more than 6,000 retail leases, often with unique terms and conditions, many of which have variable lease payments that depend on an index or a rate. It would be a significant burden (for what they viewed as little benefit) to reassess the lease payments for each of those leases that include payments that depend on an index or a rate at each reporting date.