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	Subsequent recognition and measurement of variable payments for asset purchases

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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. With regard to the subsequent accounting for a financial liability to make variable payments, the Interpretations Committee has previously tentatively decided that:

   (a) the remeasurement of the liability, in accordance with paragraph AG7 of IAS 39 *Financial Instruments: Recognition and Measurement*, corresponds entirely to an interest expense (calculated using the revised effective interest rate) that should be recognised in profit or loss. Paragraph AG7 applies to the accounting for floating rate instruments. It would therefore apply, for example, to the accounting for liabilities to make variable payments that are dependent on an interest rate (such as LIBOR).

(b) for other liabilities (ie those that are not floating rate liabilities):

(i) adjustments of the financial liability resulting from the amortisation of the financial liability (using the original effective interest rate) correspond to an interest expense that is recognised in profit or loss;

(ii) adjustments of the financial liability that result from the revision of the estimates of payments that were included in the initial measurement of the financial liability should be recognised as an adjustment to the cost of the corresponding asset; and

(iii) adjustments of the financial liability that result from the recognition of variable payments that were excluded from the initial measurement of the financial liability should be recognised as corresponding adjustments to the cost of the asset, to the extent that those payments are associated with future economic benefits to be derived from the asset.

3. Additional details of the previous discussions, tentative decisions of the Interpretations Committee and the alternative views considered have been reproduced in Appendix A of this paper. The previous tentative decisions were based partly on the provisions of IAS 39. At the Interpretations Committee meeting in September 2015, we provided the Interpretations Committee with an analysis of the impact of IFRS 9 *Financial Instruments* on those decisions. As noted in Agenda Paper 06A of that meeting, we do not think that issuing IFRS 9 has had any significant impact on the tentative decisions reached by the Interpretations Committee in the past.

4. If the Interpretations Committee concludes that the business combinations principles should be applied to the initial accounting for variable payments for asset purchases, we think that it should consider whether those principles should also be applied to the subsequent accounting for these payments. Alternatively, if the Interpretations Committee concludes that the leasing principles should be applied to the initial accounting for variable payments, we think that it should consider whether these principles should also be applied to the subsequent accounting for these payments. We have explored both of these alternatives and have provided our analysis and recommendation in the following paragraphs.

Structure of the paper

5. This paper is organised as follows:

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

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

   (c) questions for the Interpretations Committee; and

   (d) Appendix A—summary of prior discussions.

Analysis of applying the business combination principles to the subsequent recognition and measurement of variable payments for asset purchases

6. If the business combination principles are applied to the initial accounting for variable payments for asset purchases, we think that the Interpretations Committee should consider whether the business combination principles should also be applied to the subsequent accounting for those payments.

7. Subsequent changes to contingent consideration in a business combination are recorded through profit or loss. In developing the principles for subsequent accounting for contingent consideration in a business combination, the IASB noted in paragraph BC357 of IFRS 3 *Business Combinations* that (emphasis added):

   > ... the boards concluded that subsequent changes in the fair value of a liability for contingent consideration do not affect the acquisition-date fair value of the consideration transferred. Rather, those subsequent changes in value are generally directly related to post-combination events and changes in circumstances related to the combined entity. Thus, subsequent changes in value for post-combination events and circumstances should not affect the measurement of the consideration transferred or goodwill on the acquisition date. (The boards acknowledge that some changes in fair value *might result from events and circumstances related in part to a pre-combination period*. But that part of the change is usually

indistinguishable from the part related to the post-combination period and the boards concluded that the benefits in those limited circumstances that might result from making such fine distinctions would not justify the costs that such a requirement would impose.)

8. An asset purchase transaction generally involves a single asset and, therefore, we think that it may be easier to identify whether changes in fair value result from events and circumstances related, in part, to pre-combination periods. Consequently, we do not think all subsequent changes should be recorded through profit or loss.

Staff recommendation

9. We think that if the business combination principles are applied to the initial accounting for variable payments in an asset acquisition, the Interpretations Committee should retain its previous tentative decisions on subsequent accounting as outlined in paragraph 2. The provision in paragraph 2(b)(iii) will not be needed, because all payments will be included in the initial measurement of the liability.

Analysis of applying the leasing principles to the subsequent recognition and measurement of variable payments for asset purchases

10. If the leasing principles are applied to the initial accounting for variable payments for asset purchases, the Interpretations Committee could consider whether the leasing principles should also be applied to the subsequent accounting for those payments.

11. If the leasing principles were to be applied to the *subsequent accounting* for variable payments for asset purchases, we think that:

    (a) for variable payments that are based on an index or a rate, the amount of the remeasurement of the lease liability resulting from a change in the index or rate should be recognised with a corresponding adjustment to the asset; and

    (b) for variable payments that have not been included in the initial measurement of the liability, the amounts should be recognised in profit or loss in the period in which the obligation for those payments is incurred (unless the costs are included in the carrying amount of another asset in accordance with other applicable Standards).

12. This would differ from the Interpretations Committee's previous decisions on subsequent accounting for variable payments, because:

    (a) for variable payments based on an index or a rate, the remeasurement is recognised against the cost of the asset in accordance with the principles in the Leases project. The previous tentative decisions of the Interpretations Committee would require the remeasurement of floating rate liabilities to be recorded in profit or loss and the remeasurement of liabilities that are not floating rate liabilities to be recorded against the cost of the asset.

    (b) for variable payments that are not included in the initial measurement of the liability, the Interpretations Committee had tentatively decided that adjustments that result from the recognition of variable payments that were excluded from the initial measurement of the financial liability should be recognised as corresponding adjustments to the cost of the asset, to the extent that those payments are associated with future economic benefits to be derived from the asset. In accordance with the principles in the Leases project, such amounts would be recognised against profit or loss.

13. In the following section we have presented our analysis of whether the Interpretations Committee should adopt the leasing principles for the subsequent accounting for variable payments for asset purchases.

Subsequent accounting for variable payments based on an index or a rate

14. The IASB decided that any adjustments to the lease liability relating to the reassessment of variable lease payments that depend on an index or a rate should be recognised as an adjustment to the right-of-use asset. It noted that some may view the effect of a change in an index or a rate on the right-of-use asset as a gain or loss in the current period, because the change in index or rate could be viewed as an event relating to the current period. However, in the IASB's view, updating the carrying amount of the right-of-use asset appropriately updates the measurement of the cost of the right-of-use asset on the basis of updated information.

15. If the liability to make variable payments for asset purchases has been initially measured using the spot rate and did not include any expectations for future rate or inflation changes, we think a similar rationale would apply and the corresponding adjustment should be reflected against the cost of the asset as a change in estimate (as the initial measurement would not have included any estimates for future changes). We also think that this approach will be straightforward to apply because an entity will not be required to assess if the liability is a floating- or a fixed-rate liability, which we understand can be problematic in certain instances (such as for inflation indexes, which are common in several service concession arrangements and may also be seen in some asset purchase transactions).

Subsequent accounting for variable payments that are not dependent on an index or a rate

16. Where the variable payments are not dependent on an index or a rate (such as those that are dependent on the purchaser's future activity), we do not think that all adjustments should be recorded through profit or loss. We think that variable payments for asset purchases can in some instances be associated with future economic benefits to be derived from the asset (such as payments relating to increased production capacity of an asset or for a milestone payment made in a research and development project, because the milestone payment could relate to future sales to be derived from the asset).

17. Consequently, we think that the Interpretations Committee should retain its previous decision to recognise those payments as corresponding adjustments to the cost of the asset, to the extent that those payments are associated with future economic benefits to be derived from the asset.

Staff recommendation

18. If the leasing principles are applied to the initial accounting for variable payments to make asset purchases, we recommend that:

    (a) for subsequent accounting for variable payments based on an index or a rate, the Interpretations Committee should adopt the principles developed in the Leases project (ie adjustments should be recorded against the cost of the asset); and

(b) for subsequent accounting for variable payments that are not dependent on an index or a rate (such as purchaser's future activity), the Interpretations Committee should retain its previous decision to recognise those payments as corresponding adjustments to the cost of the asset to the extent that those payments are associated with future economic benefits to be derived from the asset.

Questions to the Interpretations Committee

1. If the Interpretations Committee decides that the business combination principles should be applied to the initial accounting for variable payments for asset purchases, does it agree with the staff recommendation to retain its previous tentative decisions on the subsequent accounting for these payments?
2. If the Interpretations Committee decides that the leasing principles should be applied to the initial accounting for variable payments for asset purchases, does it agree with the staff recommendation noted in paragraph 0 for the subsequent accounting for these payments?

Appendix A
Prior discussions[1]

Summary of prior discussions and tentative decisions on subsequent accounting for variable payments for asset purchases

A1. In this appendix, we present the following:

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

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

A2. It should be noted that the initial accounting for variable payments affects the subsequent accounting for those variable payments:

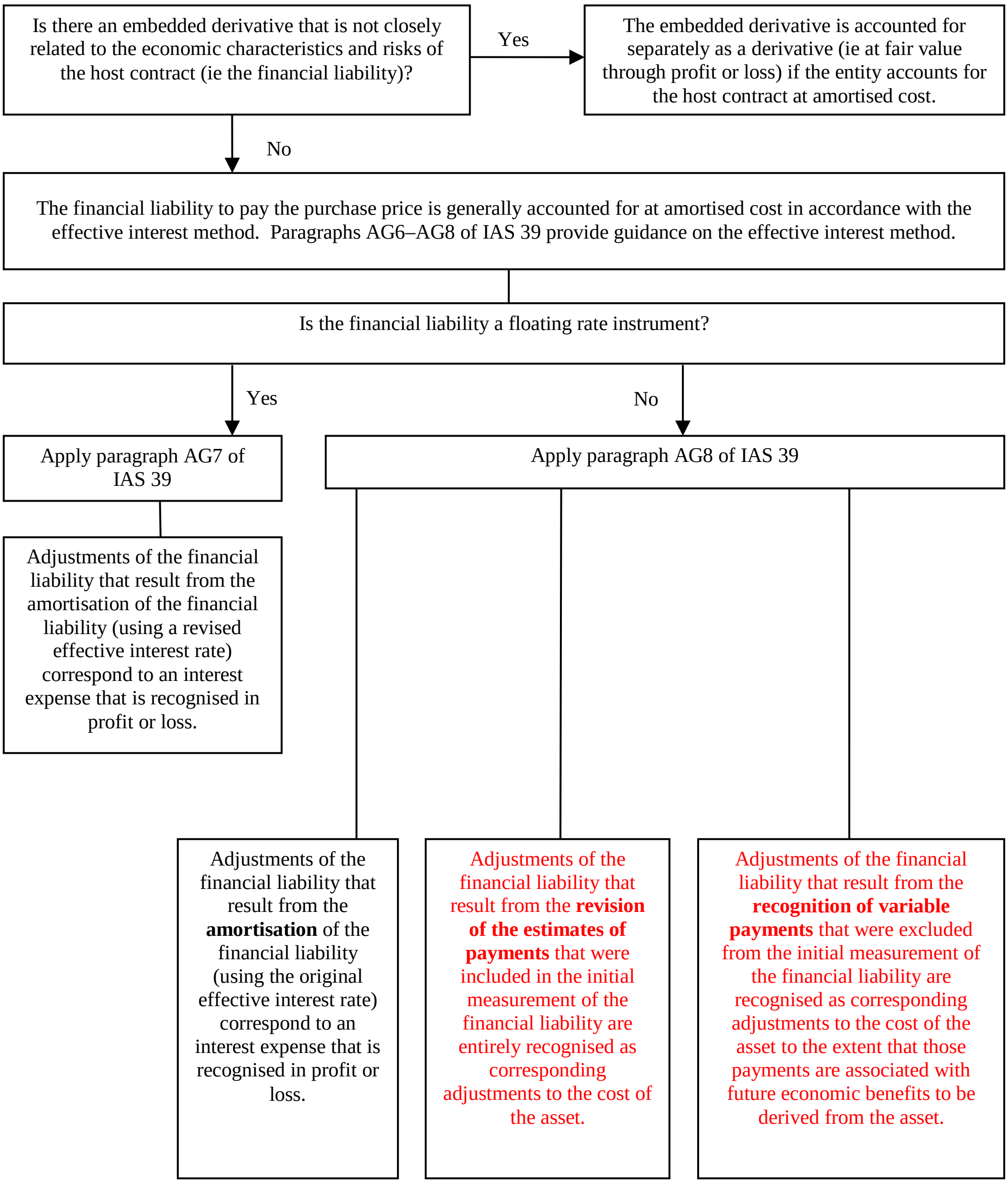
A3. If the variable payments are recognised on the date of purchase of the asset, then the issue regarding the subsequent accounting is to decide how to account for adjustments of the financial liability that result from the **revision of the estimates of payments**.

A4. If the variable payments are recognised only when the activity requiring the payment is performed, then the issue is to decide how to account for the recognition of variable payments that were previously excluded from the initial measurement of the financial liability.

A5. As a result, the Interpretations Committee's analysis takes into account the initial accounting under both Alternative 1 and Alternative 2.

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

Summary of previous tentative decisions of the Interpretations Committee on subsequent accounting for variable payments for asset purchases (from January 2013)



A6. The Interpretations Committee's detailed analysis regarding the subsequent accounting for variable payments is the following:

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

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

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

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

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

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

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

(e) according to paragraph AG8 of IAS 39, remeasurement of the liability that is due to the revision of the estimated cash flows does not alter the EIR. The entity recalculates the carrying amount of the liability by computing the present value of the estimated future cash flows at the financial instrument's original EIR. The result is that the entity accounts for an adjustment to the carrying amount of the liability (referred to as the 'AG8 adjustment' in this paper). The Interpretations Committee thinks that the interest expense in each period (that is recognised in profit or loss) corresponds to the amount calculated using the original EIR. It also thinks that the AG8 adjustment of the carrying amount of the liability (that relates to the effect of the revision of the estimated future cash flows) is not an interest expense (or an interest income). Instead, it thinks that this adjustment relates to the purchase transaction itself (when dealing with variable payments for an asset purchase).

(f) the Interpretations Committee thinks that the original EIR (within the context of applying paragraph AG8 of IAS 39 to the separate acquisition of an asset) should be initially set to equal the purchaser's incremental borrowing rate on the date of purchase of the asset when the implicit interest rate in the purchase contract is not readily determinable. The purchaser's incremental borrowing rate is the interest rate that reflects the rate at which the purchaser could borrow a similar amount in the same currency, for the same duration and with similar collateral as in the purchase agreement.

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

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

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

(ii) if the variable payments are not initially included in the measurement of the liability (ie Alternative 2), the Interpretations Committee noted that the AG8 adjustment of the liability does not correspond to a change of estimate. In that case, it thinks that this adjustment should be accounted for as an asset to the extent that the payments are associated with future economic benefits to be derived from the underlying asset. This analysis is consistent with the definition of an 'asset'. It should be noted that this analysis deals with situations in which the variable payments are excluded from the initial measurement of the financial liability (ie Alternative 2).

This is because the Interpretations Committee could not reach a consensus on whether all variable payments should be included in the initial measurement of the financial liability. The Interpretations Committee acknowledges that judgement may be required to allocate between past economic benefits and future economic benefits but it does not think that guidance should be provided on how to make this allocation.