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IFRS Interpretations Committee Meeting

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

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Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request to address an issue that is related to the accounting for variable payments for the purchases of property, plant and equipment (PPE) and intangible assets outside of a business combination (hereafter referred to as 'variable payments for asset purchases').

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

   (a) **variable payments that are dependent on an index or a rate (such as LIBOR, inflation or the consumer price index)**. These variable payments are common in licence agreements with the amount increasing at the end of each year based on the consumer price index or some other index or rate.

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

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

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

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

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

4. At its November 2012 meeting, the Interpretations Committee discussed the **initial accounting** for variable payments. It discussed the subsequent accounting for a

financial liability to make variable payments at its meetings in January and March 2013.

5. With regards to the initial accounting for variable payments:

(a) the Interpretations Committee observed that there were two diverging interpretations of the requirements in IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* regarding the timing of the recognition of the liability to make variable payments for the separate acquisition of a tangible/intangible asset:

(i) View 1—all variable payments meet the initial recognition criteria of a financial liability on the date of purchase of the asset; and

(ii) View 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.

(b) the Interpretations Committee could not reach a consensus on whether the variable payments that are dependent on the purchaser's future activity should be excluded from the initial measurement of the liability until that activity is performed; and

(c) 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 in accordance with IAS 32/IAS 39/IFRS 9 (provided that the asset has been received).

6. With regards to the **subsequent accounting** for a financial liability to make variable payments, the Interpretations Committee tentatively decided that:

(a) the remeasurement of the liability, in accordance with paragraph AG7 of IAS 39, 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.

7. A more detailed analysis of the Interpretations Committee's discussions, rationale and prior tentative decisions on the initial and subsequent accounting for these variable payments can be found in Agenda Paper 14 of the IASB's meeting in July 2013. Relevant extracts of that paper have been reproduced in Appendix A of this paper for ease of reference.

8. The Interpretations Committee decided to recommend to the IASB that it should amend IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IAS 39 to require that the subsequent adjustment of the carrying amount of a financial liability, which is not a floating rate instrument, be recognised as a corresponding adjustment to the cost of the corresponding asset in certain circumstances (see paragraph 6). These proposals did not include any amendments related to the initial accounting for variable payments in an asset purchase.

9. At its July 2013 meeting, the IASB noted that the initial accounting for variable payments affects the subsequent accounting. Some IASB members expressed the view that the initial and subsequent accounting for variable payments for the purchase

of assets are linked and should be addressed comprehensively. The IASB also noted that accounting for variable payments is a topic that was discussed as part of the Leases and *Conceptual Framework* projects. The IASB decided that it would reconsider the accounting for variable payments for the acquisition of tangible or intangible assets after the proposals in the Exposure Draft *Leases* (the 'Leases ED'), which was published in May 2013, have been redeliberated.

10. The IASB has substantially completed its redeliberations on the proposals in the Leases ED. We have also updated our outreach with constituents on the issue of variable payments for asset purchases, a summary of which has been provided later in the paper. The objective of this paper is to provide the Interpretations Committee with the results of our outreach, together with a summary of the discussions and tentative decisions to date, with the aim of assisting the Interpretations Committee in forming a view on how best to take this project forward (as discussed further in Agenda Paper 06). This paper also provides a high-level overview and discusses the related impact of the relevant conclusions reached by the IASB as part of the Leases and *Conceptual Framework* projects.

11. The Interpretations Committee's previous tentative decisions on subsequent accounting for variable payments were based on paragraphs AG7–AG8 of IAS 39. IFRS 9 was recently issued and replaces the guidance in IAS 39. We have included a section in this paper that analyses the effect, if any, that the issuance of IFRS 9 has on previous tentative decisions reached by the Interpretations Committee.

Structure of the paper

12. The structure of the paper is as follows:

    (a) summary of outreach activities;

    (b) accounting for variable payments in the Leases project and implications for variable payments in asset purchases;

    (c) proposals in the *Conceptual Framework* Exposure Draft for liabilities;

    (d) update for potential implications of IFRS 9; and

    (e) Appendix A—Prior discussions.

Summary of outreach activities

13. We sent requests to the International Forum of Accounting Standard-Setters, securities regulators, global accounting firms, a pharmaceutical industry group and certain companies within the construction, infrastructure and extractive industries. We asked the following questions:

    (a) How common are arrangements for variable payments for the separate acquisition of PPE or intangible assets (not as part of a business combination) in your jurisdiction? Which industries, if any, do you observe these types of arrangements being more common in?

    (b) In your jurisdiction, have you observed these types of arrangements being common for the acquisition of inventories?

14. To the extent these transactions were common in their jurisdictions, we also asked respondents to provide us with the following input:

    (a) In your jurisdiction, what is the predominant approach to recognising variable payment arrangements on initial acquisition of the asset and have you observed significant diversity of practice in this area? What is the basis for the approach taken?

    (b) Is the approach to recognising variable payment arrangements on initial acquisition of the asset affected by the nature of the variable payment arrangement (for example, a different accounting treatment might apply to variable payments dependent on an index or a rate versus those dependent on the purchaser's future activity)?

    (c) In your jurisdiction, what is the predominant approach to recognising subsequent adjustments to variable payment arrangements (ie through profit or loss or against the cost of the asset or other) and have you observed significant diversity of practice in this area? What is the basis for the approach taken?

15. The views received represent informal opinions and do not reflect the formal views of those organisations.

16. The responses indicate that variable payments for asset purchases are common across several jurisdictions and industries. The pharmaceutical industry was most commonly identified by respondents as an industry in which such arrangements are common. Other industries identified by several respondents included, but were not limited to, the following:

    (a) mining, oil and gas and other extractive industries;

    (b) telecommunications, media and entertainment, biotechnology and/or other hi-tech industries; and

    (c) real estate.

17. A majority of the respondents noted that such arrangements were not common for the acquisition of inventories. However, some respondents noted the following:

    (a) volume-based rebates and discounts are common across a variety of sectors.

    (b) such arrangements are sometimes seen in the context of real estate developers in which there may be variable payments for land that has been classified as inventory.

    (c) provisional invoicing is sometimes used in the extractive industry for contracts for the sale of mineral resources (for example, a mine that does not have a smelter may sell its concentration to a refiner who smelts and extracts various elements for sale to third parties). In such instances, the refiner may pay an initial amount on delivery, which is subsequently adjusted to reflect the actual minerals content and changes in mineral prices.

    (d) a respondent noted that while not common, some arrangements in the wholesale industry exist when initial acquisition prices for certain commodities were based on provisional prices with adjustments being made on the basis of whether or not predetermined targets were achieved. In addition, the initial acquisition prices of commodities (such as grains and petroleum products) are sometimes determined by reference to their market prices on the transaction date, which may be adjusted to reflect subsequent changes in the market price on the settlement date.

18. The responses indicated that there is no prevalent approach to account for variable payments for asset purchases. While predominant approaches may exist for certain industries and/or within certain jurisdictions, significant diversity continues to exist in the following areas:

    (a) recognition of variable payments on initial purchase of the asset; and

    (b) recognition of subsequent adjustments to variable payments.

19. The reasons for the diversity in views and the different approaches followed are consistent with those discussed by the Interpretations Committee in the past, a summary of which has been presented in Appendix A of this paper.

20. The following paragraphs present in more detail the responses received by nature of respondent.

Responses from national standard-setters and accounting networks

21. We received eight responses from national standard-setters. The geographical breakdown for the responses received from the national standard-setters is as follows:

Geographical region	**Number of respondents**
Asia	2
Europe	1
Americas	2
Oceania	1
Africa	2
Total respondents	**8**

22. We also received responses from the global IFRS desks of six accounting networks.

23. Three of the national standard-setters noted that this issue is not common within their jurisdictions. All of the accounting networks and the other national standard-setters noted that such payment arrangements were common within their respective jurisdictions and across several industries. Some responses indicated that while the basis of variability may differ across arrangements, payments dependent on future activity or use of the asset (such as sales, development milestones, etc) were more common than those based on indexes or rates.

24. The responses confirmed that significant diversity continues to exist in accounting for such arrangements. Some respondents noted the prevalence of a particular view or a predominant approach within particular industries, jurisdictions or type of arrangements. The differing views and rationales for those views were consistent with those discussed by the Interpretations Committee in the past, a summary of which has been reproduced in Appendix A of this paper.

Responses from securities regulators

25. We received responses from two organisations representing groups of regulators.

26. One respondent noted that such arrangements were not common except within one jurisdiction. The predominant approach in that jurisdiction was to include a best estimate of the variable payments in the initial measurement of the asset. Subsequent adjustments (which were dependent on the purchaser's future activity) were recognised as a modification of the cost of the asset.

27. The response received from the second respondent indicated that two jurisdictions had some experience with this issue. The predominant approach in one jurisdiction was to include a best estimate of the variable payments in the initial measurement of the asset, with subsequent adjustments being recognised as part of the cost of the asset. The other jurisdiction indicated that the variable payments were only recognised when the activity associated with the payment was performed.

Responses from companies in the pharmaceutical industry

28. We received responses from four companies in the pharmaceutical industry. All respondents noted that variable payment arrangements are very common for the acquisition of intangible assets (intellectual property for pharmaceutical compounds in development). The payments are typically based on one of the following:

    (a) development-based milestone, such as a payment due on successfully completing a specific phase of development or achieving regulatory approval;

(b) sales-based milestone, such as a payment due on achieving a specified threshold of sales; or

(c) sales-based royalty payment, such as a payment that is based on a specified percentage of sales over a certain threshold.

29. The respondents noted that such payments are generally accounted for consistently within the industry as follows:

(a) development-based milestones are treated as executory in nature and are recognised when the event occurs with a corresponding adjustment to the cost of the asset. Potential future development payments are disclosed as commitments in the notes to the financial statements.

(b) sales-based milestone payments are typically recognised when it is highly probable that the threshold will be met (as indicated by short-term budgets).

(c) sales-based royalty payments are expensed as the sales occur.

Other responses

30. We received three responses from companies in the extractive, infrastructure and construction industries. One respondent from the infrastructure industry noted that such payment arrangements were very common for the acquisition of PPE in emerging markets. These arrangements are commonly seen in acquisitions of machines and heavy vehicles for industrial sites, infrastructure construction and logistics. The other respondents noted that experience was limited in this area.

Feedback from CMAC/GPF members

31. As part of our outreach activities, we also discussed this issue at the joint meeting of the Global Preparers' Forum (GPF) and the Capital Markets Advisory Committee (CMAC) in June 2015.

32. GPF members shared their experiences and views in this area. The views were mixed and reflected the diversity in practice:

(a) one member noted that this issue is one of the biggest challenges facing the pharmaceutical industry. Currently there are different models for accounting for variable payments in a business combination versus an asset purchase:

(i) in the case of a variable payment in a business combination, as required by IFRS 3 *Business Combinations*, an amount (based on the probability of success) for the development milestones related to the progress of development activities as well as for all sales-based royalties or other variable payments is recognised as part of the initial recording of the intangible asset and as a liability. Any subsequent changes of the liabilities are recognised directly in profit and loss.

(ii) in the case of a variable payment in an asset acquisition, payments based on a milestone related to the progress of development are generally not recorded as a liability on the date of purchase of the asset and are recorded against the cost of the asset when the milestone is achieved. Details of the commitment to make variable payments are disclosed in the notes to the financial statements.

(iii) that member noted a preference for the guidance to be similar for both types of transactions (ie business combinations and asset purchases), but recommended doing this by revisiting the guidance on contingent consideration for business combinations.

(b) another member noted that there are two different models to account for such payments in the oil and gas sector. These payments are generally not recorded on initial purchase of the asset (because the portion of the contract relating to variable payments is viewed as executory), and are subsequently capitalised in the cost of the asset when incurred. However, if the former owners from whom the asset was purchased are employees and continue to be employed, the payment might be seen as an incentive to the employees, in which case it is recorded through profit or loss.

(c) one member commented that asset purchases are different from business combinations and cautioned against drawing an analogy to business combinations, noting that it may be appropriate to consider the guidance in

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the recognition and measurement thresholds applicable to provisions.

(d) one member expressed a preference for following an approach similar to that in the lease accounting proposals for initial recognition (ie recognising a liability for variable payments that are dependent on an index or a rate but not for other variable payments). Another member supported non-recognition of the liability on initial recognition. Both members supported recording subsequent adjustments/payments against the cost of the asset.

33. Comments from CMAC members included the following:

(a) some indicated a preference for recognising the liability at fair value on initial purchase. Views were mixed on subsequent adjustments to the liability. One member noted that adopting the 'IFRS 3 approach' (ie recognising a liability for all variable payments on initial recognition with all subsequent adjustments being recorded through the statement of profit or loss) would result in increased volatility in the statement of profit or loss and may send mixed signals to investors. For example, when the variable payments are linked to revenues, an improved performance and higher revenues would lead to increased costs for the period and an outflow of resources and vice versa.

(b) one member noted that it would be useful to differentiate between expenses covered by the successful operation of the entity (for example, when the variability is based on a percentage of sales) versus those that are not, because these payments could have a negative impact on the company's ability to continue operations. That member also commented that changes to estimates of variable payments would generally also be reflected in the changing value of the asset (if assets are measured using the revaluation model). However, if a revaluation model is not used for assets, the member agreed that a capitalisation approach (to recognise subsequent adjustments/payments) might be appropriate.

Accounting for variable payments in the Leases project and implications for variable payments in asset purchases

Accounting for variable payments in the Leases project

34. 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 a liability to make lease payments. This liability is accounted for in accordance with the requirements in the Leases Standard (and not IAS 39/IFRS 9). The accounting for the liability to make lease payments and, in particular, the accounting for variable payments to make lease payments was discussed in detail by the IASB in the Leases project.

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

36. However, we understand that the IASB members came to that conclusion for different reasons. For some members, the decision about variable lease payments linked to future performance or use was made solely for cost-benefit reasons, ie they are of the view that all variable lease payments meet the definition of a liability for the lessee. However, those members were persuaded by the feedback received from stakeholders that the costs of this approach would outweigh the benefits, particularly because of the concerns expressed about the high level of measurement uncertainty that would result from including them. 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 consider those payments to be avoidable by the

lessee and, accordingly, would conclude that the lessee does not have a present obligation to make those payments. In addition, variable lease payments linked to future performance or use could be viewed as a means by which the lessee and lessor can share future profits to be derived from the use of the asset.

37. 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 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.

38. For variable lease payments dependent on an index or a rate, the IASB decided to require an entity to determine payments at initial recognition using the index or rate at the commencement date. The decision to not require forecasting techniques to be used in determining payments at initial recognition was based on a cost-benefit assessment. In the IASB's view, forecasting techniques should 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 entities may not have readily available, and may result in measurement uncertainty. The IASB noted that the usefulness of the additional information obtained using such a forecast would frequently not justify the costs of obtaining it.

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

40. For variable lease payments that have not been included in the lease liability (such as those that are based on future activity of the lessee), the IASB concluded that the lessee shall recognise these amounts in profit or loss in the period in which the obligation for those payments incurred (unless the costs are included in the carrying amount of another asset in accordance with other applicable Standards).

41. For variable lease payments that are based on an index or a rate, the IASB concluded that 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 right-of-use asset.

42. The IASB has decided that a lessee should reassess variable lease payments that depend on an index or a rate only when there is a change in the cash flows resulting from a change in the reference index or rate. The IASB acknowledged that this requirement provides less relevant information than reassessing lease payments at each reporting date, because a lessee will not remeasure the lease liability to reflect the relevant index or rate at every reporting date. Nonetheless, in the IASB's view, this approach is a cost-effective way to update the liability measurement to reflect changes to variable lease payments.

Implications for accounting for variable payments for asset purchases

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

(a) variable payments that are dependent on an index or a rate, or are, in substance, fixed payments (but structured as variable payments), will be included in the initial measurement of the liability on the date of purchase of the asset; and

(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.

44. Previously, the Interpretations Committee could not reach a consensus on whether the variable payments that are dependent on the purchaser's future activity should be excluded from the initial measurement of the liability until that activity is performed. In all other cases (ie when 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.

45. For variable payments that are dependent on an index or a rate, the Interpretations Committee will have to decide whether such liabilities should be measured at fair

value or if they should be measured using the index or rate at the date of purchase of the asset. We think that such liabilities should be measured using the index or rate at the date of purchase of the asset. This is because:

(a) in developing the principles in the Leases project, the IASB noted that forecasting changes in an index or a rate requires macroeconomic information that entities may not have readily available and may result in measurement uncertainty. The IASB noted that the usefulness of the additional information obtained using such a forecast would frequently not justify the costs of obtaining it. We think the same consideration applies to variable payments for asset purchases and we do not think that the benefits outweigh the costs.

(b) we do not think a measurement basis that is different from the principles developed in the Leases project should be applied to variable payments for asset purchases, because this could provide opportunities for structuring contracts to achieve a particular accounting outcome.

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

(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).

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

(a) for variable payments that are included in the initial measurement of the liability, 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 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.

48. The Interpretations Committee will have to decide whether it should reconfirm its previous decisions on subsequent accounting for variable payments in an asset purchase or whether it should revisit its decisions based on the principles developed in the Leases project.

49. We think that 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. This will create consistency with accounting for leases and will reduce the need to identify whether a liability is fixed or floating, which we understand can be problematic in certain instances (such as for inflation indexes which are common in asset purchases and service concession arrangements – see example 4 of Agenda Paper 06C).

50. For subsequent accounting for variable payments that are not dependent on an index or a rate (such as purchaser's future activity), 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. Adopting the leases principles would result in all adjustments being recorded through the profit or loss. We think that variable payments for asset purchases can in many instances be associated with future economic benefits to be derived from the asset (such as for a milestone payment made in a research and development project, as the milestone

payment could relate to future sales to be derived from the asset – see example 1 of Agenda Paper 06C).

51. Obligations under a lease contract are generally scoped out of IFRS 9 and are accounted for under the Standard applicable to lease contracts (currently IAS 17 *Leases*). Paragraph 2.1 of IFRS 9 states that:

> This Standard shall be applied by all entities to all types of financial instruments except:
>
> (a) …
>
> (b) rights and obligations under leases to which IAS 17 Leases applies. However:
>
> (i) lease receivables recognised by a lessor are subject to the derecognition and impairment requirements of this Standard;
>
> (ii) finance lease payables recognised by a lessee are subject to the derecognition requirements of this Standard; and
>
> (iii) derivatives that are embedded in leases are subject to the embedded derivatives requirements of this Standard.
>
> (c) …

52. We understand that there will continue to be similar scope exceptions when the new Leases Standard is effective - obligations under lease contracts will continue to be primarily accounted for under the Standard applicable to lease contracts.

53. Consequently, if the proposals in the Leases project are applied to initial and/or subsequent accounting for variable payments for asset purchases, we think that the some aspects of recognition and measurement for variable payments for asset purchases will have to be scoped out of IFRS 9 and additional guidance will need to be included in IAS 16 and IAS 38.

54. Agenda Paper 6C provides some examples of variable payments in an asset purchase and illustrates the impact of applying the principles developed in the Leases project.

Proposals in the *Conceptual Framework* Exposure Draft for liabilities

55. The IASB published the Exposure Draft *Conceptual Framework for Financial Reporting* (the 'CF ED') in May 2015. The comment period ends on 26 October 2015. The CF ED specifically provides guidance in determining whether a 'present' obligation exists if the eventual need to transfer economic resources depends on the entity's future actions. The CF ED 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.

56. Paragraph 4.32 of the CF ED states that:

> 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.

57. Paragraph 4.34 of the CF ED also mentions 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.

Analysis of relevant guidance in IFRS 9

58. The Interpretations Committee's previous tentative decisions on subsequent accounting for variable payments were based on paragraphs AG7–AG8 of IAS 39. IFRS 9 was recently issued and replaces the guidance in IAS 39. A summary of the

previous discussions and tentative decisions of the Interpretations Committee has been included in Appendix A of this paper.

59. In particular, the Interpretations Committee had noted the following:

(a) a financial liability arising from the separate purchase of an asset is 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.

(b) 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 thought that the remeasurement of the liability in accordance with paragraph AG7 normally corresponds entirely to an interest expense (calculated using the revised effective interest rate) that should be recognised in profit or loss.

(c) 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.

(d) according to paragraph AG8 of IAS 39, remeasurement of the liability that is due to a revision of estimated cash flows does not alter the effective interest rate. The entity recalculates the carrying amount of the liability by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. 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 effective interest rate. It also thinks that the AG8 adjustment of the carrying amount of the liability (that relates to the effect of the revision of estimated future cash flows) is not an interest expense (or an interest income). Instead, it thinks that this adjustment relates to the purchase transaction itself (when dealing with variable payments for an asset purchase).

(e) 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 thought 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.

60. Paragraph AG7 of IAS 39 stated:

> For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

61. The wording in this paragraph was carried over unchanged into paragraph B5.4.5 of IFRS 9.

62. Paragraph AG8 of IAS 39 stated:

> If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92. The adjustment is recognised in profit or loss as income or expense. If a financial asset is reclassified in accordance with paragraph 50B, 50D or 50E, and the entity subsequently increases its estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase shall be recognised as an adjustment to the effective interest rate from the date of the change in estimate rather than as an adjustment to the carrying amount of the asset at the date of the change in estimate.

63. Paragraph B5.4.6 of IFRS 9 is equivalent to paragraph AG8 of IAS 39. It states:

> If an entity revises its estimates of payments or receipts (excluding modifications in accordance with paragraph 5.4.3 and changes in estimates of expected credit losses), it shall adjust the gross carrying amount of the financial asset or amortised cost of a financial liability (or group of financial instruments) to reflect actual and revised estimated contractual cash flows. The entity recalculates the gross carrying amount of the financial asset or amortised cost of the financial liability as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated

> in accordance with paragraph 6.5.10. The adjustment is recognised in profit or loss as income or expense.

64. Similar to paragraph AG8 of IAS 39, paragraph B5.4.6 of IFRS 9 requires an entity to adjust the amortised cost of a financial liability if an entity revises its estimates of payments or receipts. The amortised cost of a financial liability is calculated as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's original effective interest rate. It also requires the adjustment to be recognised in profit or loss.

65. The Basis for Conclusions on IFRS 9 that discuss the effective interest rate (paragraphs BCZ5.65–BCZ 5.71) has been carried forward from the Basis for Conclusions on IAS 39 (paragraphs BC30–BC35A). No changes were made to these paragraphs other than to update cross-references to the Standards and reflect minor editorial changes. This indicates that no significant changes were made to the requirements of the application of the effective interest rate method.

66. As the relevant portions of the wording in paragraphs B5.4.5–B5.4.6 of IFRS 9 are consistent with the wording in paragraphs AG7–AG8 of IAS 39 and no significant changes have been made to this guidance, we do not think the issuance of IFRS 9 has any significant impact on the tentative decisions reached by the Interpretations Committee in the past.

Next steps

67. Our outreach has confirmed that variable payment arrangements for asset purchases are common across several jurisdictions and industries. Significant diversity continues to exist in the accounting for such payment arrangements. For a discussion on the appropriate way forward for this project please refer to Agenda Paper 06.

Appendix A
Prior discussions[1]

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

A1. The Interpretations Committee observed that the obligation to pay a variable payment for the separate acquisition of an asset arises from a contract. As a result, such a variable payment should be accounted for in accordance with the requirements in IAS 32/IAS 39/IFRS 9.

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;

(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.

[1] Excerpts of Agenda Paper 14 of IASB meeting in July 2013

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 where the variable payments are not dependent on the purchaser's future activity), it tentatively agreed that the fair value of those variable payments should be included in the initial measurement of the liability on the date of purchase of the asset. The arguments used by the proponents of each alternative are shown below.

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

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.

<u>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</u>

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

A14. Lastly, proponents of Alternative 2 point to the guidance in IAS 39 regarding executory contracts (paragraphs 5, AG35 (b) and Guidance on implementing IAS 39, Section A *Scope*, paragraph A.1). Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement.

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 PPE has been delivered to the purchaser; or

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

Summary of the Interpretations Committee's prior discussions and tentative decisions regarding the subsequent accounting for variable payments

A18. We present below:

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

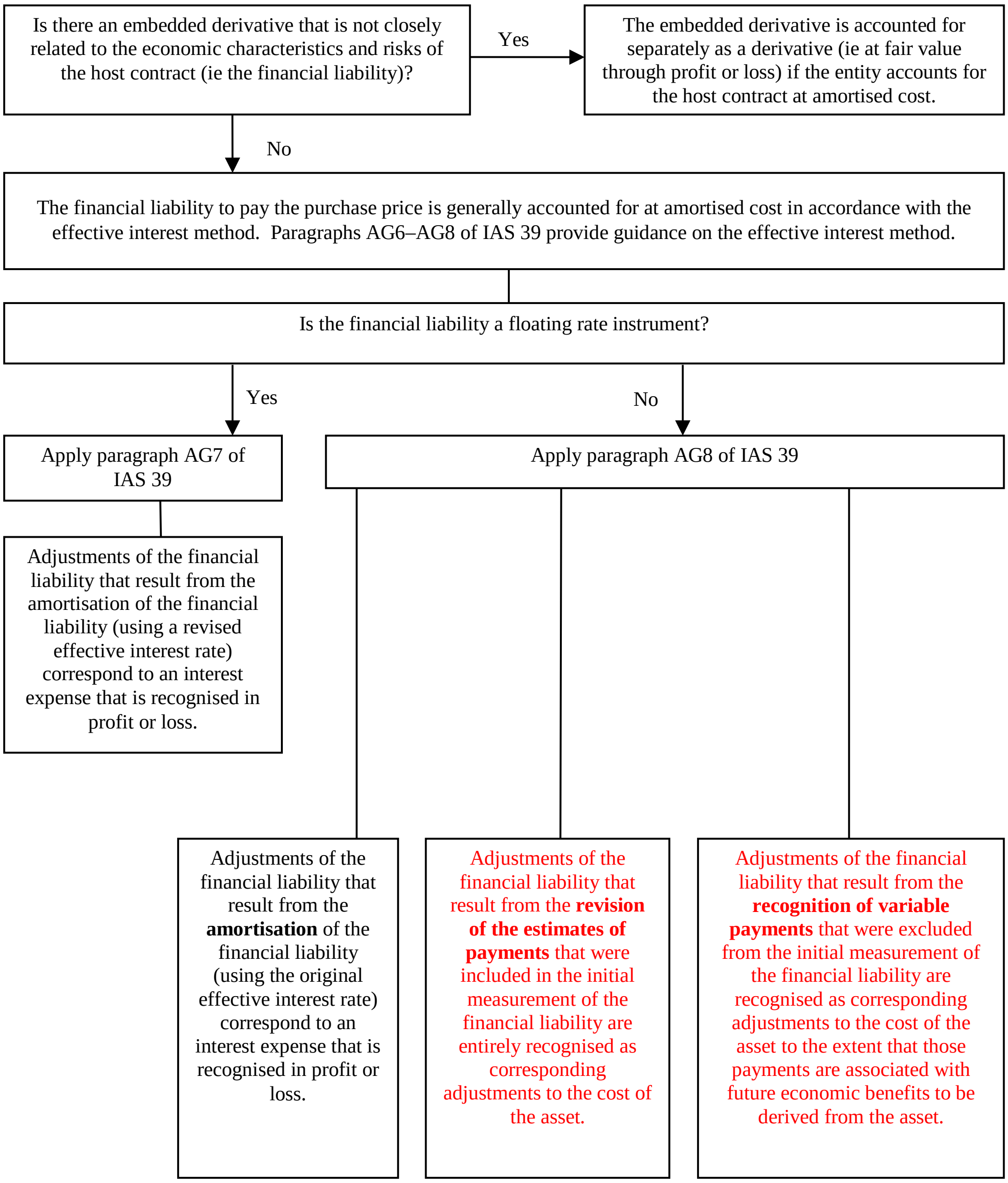
(b) a detailed analysis of the Interpretations Committee's discussions.

A19. It should be noted that the initial accounting for variable payments affects the subsequent accounting for those variable payments:

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

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

A20. As a result, the Interpretations Committee's analysis takes into account the initial accounting under both Alternative 1 and Alternative 2.


Is there an embedded derivative that is not closely related to the economic characteristics and risks of the host contract (ie the financial liability)?
Yes
The embedded derivative is accounted for separately as a derivative (ie at fair value through profit or loss) if the entity accounts for the host contract at amortised cost.
No
The financial liability to pay the purchase price is generally 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.
Is the financial liability a floating rate instrument?
Yes
No
Apply paragraph AG7 of IAS 39
Apply paragraph AG8 of IAS 39
Adjustments of the financial liability that result from the amortisation of the financial liability (using a revised effective interest rate) correspond to an interest expense that is recognised in profit or loss.
Adjustments of the financial liability that result 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.
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 are entirely recognised as corresponding adjustments to the cost of the asset.
Adjustments of the financial liability that result from the **recognition of variable payments** that were excluded from the initial measurement of the financial liability are 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.

A21. 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 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, remeasurement of the liability that is due to the revision of estimated cash flows does not alter the EIR. The entity recalculates the carrying amount of the liability by computing the present value of estimated future cash flows at the financial instrument's original

EIR. The result is that the entity accounts for an **adjustment** to the carrying amount of the liability (referred to as the '**AG8 adjustment**' in this paper). The Interpretations Committee thinks that the interest expense in each period (that is recognised in profit or loss) corresponds to the amount calculated using the original EIR. It also thinks that the AG8 adjustment of the carrying amount of the liability (that relates to the effect of the revision of estimated future cash flows) is not an interest expense (or an interest income). Instead, it thinks that this adjustment relates to the purchase transaction itself (when dealing with variable payments for an asset purchase).

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

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

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

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

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