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STAFF PAPER

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Project	**IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets***
Paper topic	Contingent payments for the separate purchase of PPE and intangible assets

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Introduction

1. The IFRS Interpretations Committee (the Committee) discussed in 2011 and 2012 the accounting for contractual payments made by an operator under a service concession arrangement (SCA) within the scope of IFRIC 12 *Service Concession Arrangements*. At the March 2012 meeting, the Committee asked the staff to analyse the accounting for variable payments made by an operator under an SCA taking into consideration the requirements for the accounting of variable payments in the Leases project.

2. It should be noted that according to IFRIC 12, variable payments made by an operator under an SCA can represent in certain circumstances consideration for a right (a licence) to charge users of the public service that meets the definition of an intangible asset in IAS 38 *Intangible Assets* (see Agenda paper 3B *Payments made by an operator to a grantor*). Consequently, this issue is linked to a previous issue discussed in 2011 by the Committee regarding contingent payments made by an entity for the separate purchase of property, plant and equipment (PPE) or intangible assets.

3. As a result, in order to address the issue of variable payments made by an operator under an SCA (which meets the definition of an intangible asset), we think that we

should first address the broader issue of contingent payments made by an entity for the separate purchase of PPE or intangible assets.

Objective of the paper

4. The objective of the paper is:

   (a) to present the proposals on the accounting for variable payments in the Leases project and the Revenue recognition project;

   (b) to present the current requirements regarding the accounting for contingent payments for the separate purchase of PPE or intangible assets;

   (c) to propose a basis of accounting for contingent payments for the separate purchase of PPE or intangible assets that is consistent with the proposals on the accounting for variable payments in the Leases project and the Revenue recognition project; and

   (d) to ask for the Committee's views.

Structure of the paper

5. The structure of the paper is the following:

   (a) characteristics of the contingent payments addressed in this paper;

   (b) common accounting treatments applied to contingent payments for the separate purchase of PPE and intangible assets;

   (c) accounting for variable payments in the Leases project and the Revenue recognition project;

   (d) accounting for contingent payments under the current literature for the separate purchase of PPE and intangible assets;

   (e) staff's recommendation;

   (f) Appendix A: Extracts from the Revenue recognition project regarding the accounting for variable payments; and

(g) Appendix B: Extracts from the Leases project regarding the accounting for variable payments.

Characteristics of the contingent payments addressed in this paper

6. Contingent payments are payments made by an entity in the event of the occurrence or non-occurrence of uncertain future events. Examples of contingent payments include:

   (a) payments payable upon the achievement of milestones specified in the purchase agreement;

   (b) payments payable upon the buyer obtaining an approval from a regulatory body;

   (c) payments that depend upon an index (such as a market index, a consumer price index or an interest rate); and

   (d) payments based on future revenues generated through the use of the asset purchased.

7. We note that some of the divergence of views on the accounting for contingent payments comes from the fact that there are two different types of contingent payments:

   (a) contingent payments whose occurrence is reasonably certain; and

   (b) contingent payments whose occurrence is *not* reasonably certain.

8. In some cases, the occurrence of the contingent event is reasonably certain at the date of recognition of the tangible/intangible asset and the amount to be paid can be estimated with a high reliability. When these contingent payments are paid, they are generally analysed as being part of the price paid for the purchase of the asset. This is because the purchaser expected to make these payments at the purchase date. In other words, the occurrence of the contingent event merely confirms what the price agreed at the purchase date was. For example, for a contingent payment payable upon a PPE reaching a standard production capacity, the expectation at the purchase date might be that the PPE will reach its standard

production capacity. For a payment payable upon the buyer obtaining an approval from a regulatory body, the expectation at the purchase date might be that the approval will be obtained, because the entity already meets all the requirements in the regulation in order to obtain the approval.

9. In other cases, the occurrence of the contingent event is *not* reasonably certain at the date of recognition of the tangible/intangible asset and the amount to be paid *cannot* be estimated with a high reliability. This is typically the case for contingent payments that are linked to the purchaser's future performance (when using the asset purchased). These contingent payments are generally analysed as being similar to *profit-sharing agreements* because they relate to the purchaser's performance *after* the purchase date. For example, a service concession arrangement might specify that an operator has a right to charge users of the public service in exchange for payments made to a grantor based on future revenues generated though the sale of the public service to the users. In this example, the operator and the grantor have agreed to share risks and rewards related to the future activity that is developed by the operator through the use of the licence purchased.

Common accounting treatments applied to contingent payments for the separate purchase of PPE and intangible assets

10. With regard to payments that are reasonably certain, a common accounting treatment is:

    (a) to account initially for a tangible/intangible asset and a liability taking into account the best estimate of the payments to be made (based on the discounted cash flows); and

    (b) to account subsequently for the remeasurement of the liability as an adjustment to the cost of the asset.

11. With regard to payments that are *not* reasonably certain (such as payments based on future revenues in a licence agreement), a common accounting treatment is to account for these payments in P/L as expenses when the contingent event occurs

(ie in the period in which the corresponding revenue is earned if the payment is based on revenues).

Accounting for variable payments in the Revenue recognition project

12. In the revised exposure draft published in 2011, if the promised amount of consideration in a contract with a customer is variable, an entity shall estimate the total amount to which it will be entitled using either the expected value or the most likely amount. The entity shall update the estimated transaction price at each reporting date to represent faithfully the circumstances present at the reporting date and the changes in circumstances during the reporting period (paragraphs 54 and 55).

13. After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which the entity expects to be entitled in exchange for the promised goods or services. An entity shall allocate to the separate performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. Amounts allocated to a satisfied performance obligation shall be recognised as revenue, or as a reduction of revenue, in the period in which the transaction price changes (paragraphs 77 and 78).

14. However, paragraphs 81-85 include a constraint on the cumulative amount of revenue that can be recognised. The cumulative amount of revenue that the entity recognises to date shall not exceed the amount to which the entity is *reasonably assured to be entitled*. If an entity is not reasonably assured to be entitled to the amount of the transaction price allocated to satisfied performance obligations, the cumulative amount of revenue recognised as of the reporting date is limited to the amount of the transaction price to which the entity is reasonably assured to be entitled.

15. We note that an entity is reasonably assured to be entitled to the amount of consideration allocated to satisfied performance obligations only if both of the following criteria are met (paragraph 81):

(a) the entity has experience with similar types of performance obligations; and

(b) the entity's experience is predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations.

16. According to paragraph 85, if an entity licences intellectual property to a customer and the customer promises to pay an additional amount of consideration that varies on the basis of the customer's subsequent sales of a good or service (for example, a sales-based royalty), *the entity is not reasonably assured to be entitled to the additional amount of consideration until the uncertainty is resolved (ie when the customer's subsequent sales occur)*. According to paragraph BC203, in those cases, both users and preparers thought that it would not be useful for an entity to recognise revenue at the inception of the contract for the total amount of the consideration to which the entity expects to be entitled. That is because that approach would inevitably require the entity to report, throughout the life of the contract, significant adjustments to the amount of revenue recognised at inception of the contract as a result of changes in circumstances. For those contracts, *users and preparers explained that the most useful information would be to recognise revenue when there is no longer uncertainty about the amount of consideration to which the entity is entitled.*

17. We also note that according to paragraph BC201, the boards decided to specify that the cumulative amount of revenue that an entity recognises should be limited to the amount to which the entity is reasonably assured to be entitled, *rather than the amount that can be reasonably estimated*. The primary reason is that in some circumstances an entity might be able to reasonably estimate an amount, even though the entity is not reasonably assured to be entitled to that amount in accordance with the proposed requirements. The boards acknowledge that the constraint is a qualitative threshold, rather than a quantitative threshold. As a result, we understand that the notion of 'reliably measured' or 'reliably estimated' is different from the notion of 'reasonably assured'.

18. Lastly, it should be noted that for the transfer of a non-financial asset (within the scope of IAS 16/IAS 38), the boards propose amending other standards to require that an entity apply (a) the proposed requirements on control to determine when to

derecognise the asset, and (b) the proposed measurement requirements to determine the amount of gain or loss to recognise upon derecognition of the asset (see paragraphs D17, D22 and D26 in Appendix D).

Accounting for variable payments in the Leases project

19. In the Leases project, we understand that the following variable payments would be included in the initial measurement of the lessee's liability to pay leases (and in the initial measurement of the right-of-use asset):

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

    (b) lease payments that depend upon an index or a rate (ie fixed lease payments that become variable because they change in proportion to the movements of an index).

20. *All the other variable payments would be excluded from the measurement of the lessee's liability*. These payments (such as lease payments based on future revenues of the lessee) would be recognised as an expense in P/L when they are incurred (ie when they become certain) unless they relate to future reporting periods. In our understanding, within the context of the Leases project, payments that are not certain are excluded from the measurement of the lessee's liability.

21. The Board also tentatively decided that:

    (a) Lease payments that depend on an index or a rate should be measured initially using the index or rate that exists at the date of commencement of the lease.

    (b) Lease payments that depend upon an index or a rate should be reassessed using the index or rate that exists at the end of each reporting period.

    (c) Lessees should reflect changes in the measurement of lease payments that depend on an index or a rate:

        (i) in P/L to the extent that those changes relate to the current reporting period; and

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

22. However, we understand that the Board is still discussing this issue.

Accounting for contingent payments under the current literature for the separate purchase of PPE and intangible assets

23. PPE and intangible assets should be accounted for in accordance with the requirements in IAS 16 *Property, Plant and Equipment* and IAS 38. Financial liabilities payable for the purchase of PPE and intangible assets 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*.

24. It should be noted that rights and obligations under leases to which IAS 17 *Leases* applies are excluded from the scope of IAS 39/IFRS 9.

Initial accounting for the tangible/intangible asset and for the financial liability

25. With regard to the initial accounting, we think that the current literature seems to require that a tangible/intangible asset and a financial liability should be initially accounted for taking into account all contingent payments based on their fair value. However, some consider that there might currently be an inconsistency between IAS 16/IAS 38 and IAS 39/IFRS 9 on the accounting for contingent payments *that cannot be measured reliably*.

26. On the liability side, we think that IAS 32/IAS 39/IFRS 9 seem to require that a financial liability should be initially accounted for taking into account all contingent payments based on their fair value, because:

    (a) Liabilities that arise from the separate acquisition of items of PPE or intangible assets are within the scope of IAS 39/IFRS 9.

    (b) Contingent payments (such as variable payments based on future revenues or variable payments based on an index) constitute financial liabilities.

Indeed, in accordance with IAS 32 (paragraph 25), variable payments based on future revenues or variable payments based on an index are beyond the control of both the issuer and the holder of the financial instrument. As a result, the issuer of the liability (ie the purchaser of the asset) does not have the unconditional right to avoid delivering cash and should recognise a financial liability.

(c) A financial liability is initially measured at fair value according to IAS 39 (paragraph 43)/IFRS 9 (paragraph 5.1.1). The fair value corresponds to the present value of the estimated cash flows. It should be noted that there is a general presumption that fair value can be measured reliably for all financial instruments, except for equity instruments that do not have a quoted market price in an active market (see the definition of the effective interest method in IAS 39 paragraph 9 and IAS 39 paragraph AG80).

27. On the asset side, we think that the current literature also seems to require, in most cases, that a tangible/intangible asset should be initially accounted for taking into account contingent payments based on their fair value. Indeed, the cost of an asset includes the fair value of the other consideration given to acquire an asset at the time of its acquisition (see the definition of 'cost' in IAS 16 paragraph 6 and IAS 38 paragraph 8). Consequently, IAS 16/IAS 38 seem to require including in the cost of the asset the fair value of contingent payments agreed in the purchase contract.

28. However, we note that IAS 16 (paragraph 7) and IAS 38 (paragraph 21) state that the cost of a tangible/intangible asset is recognised as an asset if, and only if, the cost can be measured reliably. Moreover, IAS 38 (paragraph 47) states the following:

> IAS 38.47 Paragraph 21(b) specifies that a condition for the recognition of an intangible asset is that the cost of the asset can be measured reliably. The fair value of an intangible asset for which comparable market transactions do not exist is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that asset or (b) the probabilities of the various

> estimates within the range can be reasonably assessed and used in estimating fair value.

29. We think that an estimate of the fair value of contingent payments based on the present value of the future cash flows is in most cases a reliable measure (as this notion is defined in IAS 38) and should be initially recognised in the cost. We note that according to the revised exposure-draft on revenues (paragraph BC201), an entity might be able to reasonably estimate an amount even though the entity is not reasonably assured to be entitled to that amount in accordance with the proposed requirements. However, we also think that it is not clear whether the fair value of contingent payments based on future revenues should always be considered a reliable measure (as this notion is defined in IAS 38). As a result, some might consider that paragraph 47 of IAS 38 provides an exception from recognising in the cost of an asset the fair value of contingent payments that are not reliably measurable.

30. We note that IAS 39 (paragraph AG80) provides an exception from fair value measurement *only* for investments in equity instruments (and derivatives linked to those investments) that do not have a quoted market price in an active market and that are not reliably measurable. The wording used in paragraph AG80 of IAS 39 is consistent with the wording used in paragraph 47 of IAS 38. We also note that this exception was removed from IFRS 9.

> IAS 39 AG 80 The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (…) is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

31. As a result, we observe that if the fair value of contingent payments based on future revenues was not considered a reliable measure in IAS 16/IAS 38, this would create an inconsistency between the requirement in IAS 16/IAS 38 and the

requirements in IAS 39/IFRS 9 (because the amount that should be recognised on the asset side would be different from the amount that should be recognised on the liability side).

Subsequent accounting for the tangible/intangible asset and for the financial liability

32. With regard to the subsequent accounting, we think that there is currently an inconsistency between IAS 16/IAS 38 and IAS 39/IFRS 9.

33. On the asset side, we think that the current literature seems to require that the remeasurement of the liability should be accounted for as an adjustment to the cost of the asset, because:

    (a) The cost in IAS 16 (paragraph 6) and IAS 38 (paragraph 8) is defined as the amount of cash or cash equivalent paid for the purchase of the asset (thus including all the amounts paid for the purchase of the asset).

    (b) IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* states that the cost of a tangible asset is subsequently adjusted when there are changes in the estimated timing or amount of outflows required to settle a decommissioning obligation accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

    (c) According to IAS 2 *Inventories* (paragraph 11), trade discounts and rebates are deducted in determining the cost of purchase. As a result, the cost of inventories would be subsequently adjusted if the initial estimation of discounts and rebates to be obtained was revised.

    (d) According to IFRS 3 *Business Combinations* issued in 2004 (paragraph 33), ie the 'old version' of IFRS 3 based on the cost of the business combination, goodwill is subsequently adjusted when the cost of the business combination is adjusted because of contingent payments.

34. On the liability side, we think that IAS 39/IFRS 9 seem to require that the remeasurement of the liability should be accounted for in P/L. Indeed, the financial liability is accounted for subsequently at amortised cost using the

effective interest method. According to IAS 39 (paragraph AG8 on the effective interest method), if an entity revises its estimates of payments, the entity shall adjust the carrying amount of the liability to reflect actual and revised estimated cash flows and the adjustment is recognised in P/L as income or expense.

Staff's recommendation

35. We note that the Committee previously asked the staff to consider the proposals in the Revenue recognition project and the Leases project in order to propose a basis of accounting for contingent payments for the separate purchase of PPE and intangible assets.

36. As explained in detail above, in the Revenue recognition project, we understand that:

    (a) The principle is to limit the cumulative amount of revenue recognised as of the reporting date to the amount of the transaction price to which the entity *is reasonably assured to be entitled*. In other words, revenue is recognised when there is no longer uncertainty about the amount of consideration to which the entity is entitled.

    (b) The measurement of the financial receivable excludes variable payments that are not reasonably assured. The accounting for the financial receivable is included within the scope of the future standard on revenue (and is excluded from the scope of IAS 39/IFRS 9).

    (c) If an entity licenses intellectual property to a customer and the customer promises to pay an additional amount of consideration that varies on the basis of the customer's subsequent sales of a good or service (for example, a sales-based royalty), the entity is not reasonably assured to be entitled to the additional amount of consideration until the uncertainty is resolved (ie when the customer's subsequent sales occur).

37. In the Leases project, the only variable payments that are included in the measurement of the lessee's liability are variable payments that depend on an index (ie fixed payments that become variable because they change in proportion

to the movements of an index). As a result, variable payments based on future revenues (or some other similar measurement) would be excluded from the measurement of the lessee's liability. These payments would be recognised as an expense in P/L when they are incurred (ie when they become certain) unless they relate to future periods. Although the rationale underlying this proposal is not explicitly described, we note that the Board's tentative decision is broadly consistent with the proposed requirements in the Revenue recognition project. Indeed, variable payments that depend upon an index should be considered to be reasonably assured. Although the movements of the index in the future might be difficult to estimate, the variability (corresponding to an increase or a decrease of the amount payable in proportion to the movements of the index) is generally limited. In other words, the major part of the payment can be seen as a fixed payment subject to a limited variability.

38. If the objective is to align as much as possible the accounting for variable payments for the separate purchase of PPE and intangible assets with the accounting for variable payments in the Leases project and the Revenue recognition project, we think that the recognition and measurement principles of the liability on the purchaser's side should be consistent (as much as possible) with the recognition and measurement principles of:

    (a) the financial receivable on the seller's side; and

    (b) the lessee's liability to pay leases.

39. In that case, we think that the following accounting could be proposed:

    (a) An entity would initially include the fair value of the contingent payments (ie the present value of the estimated payments) in the initial cost of the tangible/intangible asset and in the initial measurement of the liability *to the extent that the contingent payments are reasonably certain*.

        The payments would generally be estimated using the 'most likely amount' method.

    (b) An entity would subsequently account for the liability at amortised cost and would include in the remeasurement of the liability:

(i) the present value of the estimated payments that *become reasonably certain*; and

(ii) the re-estimation of the payments previously recognised.

(c) The remeasurement of the liability would be recognised:

(i) as an adjustment to the cost of the tangible/intangible asset to the extent that it relates to future reporting periods; and

(ii) in P/L to the extent that it relates to the current or prior reporting periods.

40. We think that the core issue will be to clarify the notion of 'reasonably certain'. We think that the guidance provided in the future standards on revenues and leases should be used. In that case, we note that the accounting would be different for:

(a) contingent payments that are similar to profit-sharing agreements (ie that are related to the purchaser's performance after the purchase date);

(b) other contingent payments whose occurrence is reasonably certain at the purchase date (ie the occurrence of the contingent event confirms what the price agreed at the purchase date was).

41. Indeed, contingent payments based on future revenues (or other similar measurement) would be considered to be reasonably certain only when the corresponding sales occur. Such variable payments would be *excluded* from the initial measurement of the cost of the tangible/intangible asset and the initial measurement of the liability.

42. Contingent payments whose occurrence is reasonably certain at the purchase date (including contingent payments that depend upon an index) would be included in the initial measurement of the cost of the tangible/intangible asset and in the initial measurement of the liability.

43. We also recommend using the guidance in the final standard on leases for the determination of the discount rate to be used and for the accounting of the remeasurement of liabilities that depend upon an index or a rate.

44. We provide below some examples that illustrate the application of the accounting treatment proposed above. Additional examples are provided in Agenda paper 3B *Payments made by an operator to a grantor.*

<u>Example 1:</u> A licence agreement specifies that Entity A has the right to sell a product using a specific technology in exchange for annual payments representing x per cent of the annual revenues generated through the sale of the products. Entity A considers that the payments are reasonably certain only when the corresponding products are sold. In that case, Entity A would recognise a liability when the payments are reasonably certain, ie when the corresponding products are sold. The debit entry of the liability is an expense because the payments are associated with the current reporting period.

<u>Example 2:</u> A licence agreement specifies that Entity B has the right to sell a product using a specific technology in exchange for variable payments that depend on an index (ie the only variable is the index). In that case, Entity B would initially recognise an asset and a liability for the present value of the estimated payments to be made. Entity B would subsequently remeasure the liability and account for the remeasurement (if any) (i) in P/L to the extent that it relates to the current or prior reporting periods or (ii) as an adjustment to the cost of the tangible/intangible asset to the extent that it relates to future reporting periods.

<u>Example 3:</u> Entity C purchases a patent related to a new molecule and agrees to make a first fixed payment at the date of purchase. Entity C intends to use the molecule in order to develop a new drug as part of a research and development project. Entity C has agreed to make a second fixed payment if a regulatory body gives an approval to sell the drug in a specific jurisdiction. Entity C considers that the second payment is reasonably certain only when the approval is obtained. In that case, Entity C would initially recognise an asset and a liability for the present value of the first fixed payment to be made. Entity C would subsequently include in the measurement of the liability the present value of the second payment when the approval is obtained. The remeasurement is accounted for as an adjustment to the cost of the intangible asset to the extent that it relates to future reporting periods.

45. If the Committee supports this proposal, we think that IAS 16, IAS 38, IAS 2 and IAS 39/IFRS 9 would have to be amended. In particular, we think that the accounting for the liability (for the separate purchase of a tangible/intangible asset or inventories) would have to be excluded from the scope of IAS 39/IFRS 9. We note that similar exclusions from the scope of IAS 39/IFRS 9 exist for the accounting for:

    (a) the financial receivables arising from a sale to a customer in the Revenue recognition project;

    (b) the lessor's financial asset and the lessee's financial liability arising from a lease in the Leases project.

46. We recommend aligning the effective date of the amendments to be made in the IFRS literature with the effective date of the future standards on revenue and leases.

Questions to the Committee
Does the Committee think that the accounting for contingent payments for the separate purchase of PPE and intangible assets should be aligned with the accounting for variable payments in the Leases project and the Revenue recognition project? If so, assuming that the proposed requirements in the Leases project and the Revenue recognition project on variable payments are confirmed, does the committee agree with the staff's proposal: - to exclude contingent payments that are not reasonably certain from the initial measurement of the cost of the tangible/intangible asset and of the financial liability? - to account for the remeasurement of the liability (i) as an adjustment to the cost of the tangible/intangible asset to the extent that it relates to future reporting periods (ii) in P/L to the extent that it relates to the current or previous reporting periods? - to align the effective date of the amendments to be made in the IFRS literature with the effective date of the future standards on revenue and leases?

Appendix A: Extracts of the Revenue recognition project regarding the accounting for variable payments

Variable consideration (see paragraphs B2–B9)

53 The promised amount of consideration in a contract can vary because of discounts, rebates, refunds, credits, incentives, performance bonuses, penalties, contingencies, price concessions or other similar items.

54 If the promised amount of consideration in a contract is variable, an entity shall estimate the total amount to which the entity will be entitled in exchange for transferring the promised goods or services to a customer. An entity shall update the estimated transaction price at each reporting date to represent faithfully the circumstances present at the reporting date and the changes in circumstances during the reporting period. An entity shall account for changes in the transaction price in accordance with paragraphs 77–80.

55 To estimate the transaction price, an entity shall use either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

(a) The expected value—the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts.
An expected value may be an appropriate estimate of the transaction price if an entity has a large number of contracts with similar characteristics.

(b) The most likely amount—the most likely amount is the single most likely amount in a range of possible consideration amounts (ie the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the transaction price if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

56 When estimating the transaction price, an entity shall apply one method consistently throughout the contract. In addition, an entity shall consider all the information (historical, current and forecasted) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to determine the transaction price would typically be similar to the information that management of the entity uses during the bid and proposal process and in establishing prices for promised goods or services.

57 If an entity receives consideration from a customer and expects to refund some or all of that consideration to the customer, the entity shall recognise as a refund liability the amount of consideration that the entity reasonably expects to refund to the customer. The refund liability (and corresponding change in the transaction price) shall be updated at each reporting period for changes in circumstances. To account for a refund liability relating to a sale with a right of return, an entity shall apply the proposed guidance in paragraphs B2–B9.

Changes in the transaction price

77 After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which the entity expects to be entitled in exchange for the promised goods or services.

78 An entity shall allocate to the separate performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. Amounts allocated to a satisfied performance obligation shall be recognised as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

79 An entity shall allocate a change in the transaction price entirely to one or more distinct goods or services only if the criteria in paragraph 76 are met.

80 An entity shall not reallocate the transaction price to reflect changes in stand-alone selling prices after contract inception.

Constraining the cumulative amount of revenue recognised (see paragraphs IE11–IE13)

81 If the amount of consideration to which an entity expects to be entitled is variable, the cumulative amount of revenue the entity recognises to date shall not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount of consideration allocated to satisfied performance obligations only if both of the following criteria are met:

(a) the entity has experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities); and

(b) the entity's experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations.

82 Indicators that an entity's experience (or other evidence) is not predictive of the amount of consideration to which the entity will be entitled include, but are not limited to, the following:

(a) the amount of consideration is highly susceptible to factors outside the entity's influence. Those factors include volatility in a market, the judgement of third parties, weather conditions and a high risk of obsolescence of the promised good or service.

(b) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

(c) the entity's experience (or other evidence) with similar types of performance obligations is limited.

(d) the contract has a large number and broad range of possible consideration amounts.

83 An entity shall use judgement and consider all facts and circumstances when evaluating whether the entity's experience is predictive of the amount of consideration to which it will be entitled. The presence of any one of the indicators in paragraph 82 does not necessarily mean that the entity is not reasonably assured to be entitled to an amount of consideration.

84 If an entity is not reasonably assured to be entitled to the amount of the transaction price allocated to satisfied performance obligations, the cumulative amount of revenue recognised as of the reporting date is limited to the amount of the transaction price to which the entity is reasonably assured to be entitled.

85 Notwithstanding the requirements in paragraphs 81–83, if an entity licences intellectual property (see paragraph B33) to a customer and the customer promises to pay an additional amount of consideration that varies on the basis of the customer's subsequent sales of a good or service (for example, a sales-based royalty), the entity is not reasonably assured to be entitled to the additional amount of consideration until the uncertainty is resolved (ie when the customer's subsequent sales occur).

Constraint on the cumulative amount of revenue recognised (paragraphs 81–85)

BC198 The 2010 exposure draft proposed that an entity should recognise revenue from satisfying a performance obligation only if the transaction price could be reasonably estimated. The boards then specified the criteria that would have to be met to determine whether the transaction price could be reasonably estimated. The boards decided to include a constraint on the recognition of revenue because revenue is an important measure to users of financial statements when valuing an entity and because a significant portion of errors in financial statements have related to the overstatement or premature recognition of revenue.

BC199 Most respondents supported a constraint on revenue recognition. However, some respondents noted some unintended consequences from the proposal to constrain the transaction price that would be allocated to all the performance obligations in the contract. In particular, respondents in the asset management industry noted that constraining the transaction price would not result in a pattern of revenue recognition that would faithfully depict their performance under the contract. In addition, respondents noted that if the transaction price is constrained, in some cases, an entity might not allocate any consideration to the remaining performance obligations in the contract. In such cases, those remaining performance obligations would be identified as onerous even though the entity expects those performance obligations to be profitable.

BC200 Therefore, in the proposed requirements, the boards clarified that the constraint would apply when the promised amount of consideration in a contract is variable and only to the cumulative amount of revenue recognised to date for satisfied or partially satisfied performance obligations, rather than to the amount of consideration (ie the transaction price) allocated to all performance obligations.

BC201 The boards also decided to specify that the cumulative amount of revenue an entity recognises should be limited to the amount to which the entity is reasonably assured to be entitled, rather than the amount that can be reasonably estimated. The primary reason for that change is that in some circumstances an entity might be able to reasonably estimate an amount even though the entity is not reasonably assured to be entitled to that amount in accordance with the proposed requirements. In other words, the boards decided that the term 'reasonably estimated' was appropriate in the context of the 2010 exposure draft when the boards proposed constraining the estimate of the overall transaction price. However, for the purposes of constraining the amount of revenue that an entity would recognise, the boards decided that the term 'reasonably assured' would be a more appropriate label for describing the circumstances in which the amount of revenue should be constrained. The boards acknowledge that the constraint is a qualitative threshold, rather than a quantitative threshold and is not meant to include assessments of collectibility, which are considered separately (see paragraphs BC163–BC175).

Determining when the amount of revenue recognised is reasonably assured

BC202 The boards proposed criteria in the 2010 exposure draft for when revenue should be constrained. Most respondents agreed that the criteria were appropriate and useful. Therefore, the boards decided to carry forward those criteria with some modifications as described below. Those criteria, specified in paragraph 81, are as follows:

(a) the entity has experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities)—an entity's experience with similar types of performance obligations is necessary to be able to conclude that the amount of revenue recognised is reasonably assured. Without that experience, the level of uncertainty in the amount of revenue recognised would be too high for users to find that amount useful.

In other words, a user might find it more useful if an entity were to recognise revenue only when the uncertainty is resolved. There may be circumstances in which an entity might not have such experience, such as for new offerings of goods or services or expansion into new markets. In those cases, the boards decided that another entity's experience or other evidence may be a reasonable proxy for the entity's own experience.

(b) the entity's experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations—an entity's experience (or other evidence) is necessary, but not sufficient, for the entity to conclude that it is reasonably assured to be entitled to an amount of consideration. That experience also needs to be predictive of the amount of consideration to which the entity will be entitled, for example, because the entity does not expect significant changes in circumstances from its experience with similar performance obligations in the past. The boards modified this criterion from the 2010 exposure draft, which stated that an entity's experience must be relevant, because they decided that the term 'predictive' would better align with the objective of determining and allocating the transaction price (ie to allocate to each performance obligation the amount of consideration to which the entity expects to be entitled in exchange for satisfying those performance obligations). To help an entity assess whether its experience predicts the amount of consideration, the boards decided to specify the indicators in paragraph 82. Those indicators were derived in part from existing guidance in US GAAP on estimating sales returns. Those indicators were also proposed in the 2010 exposure draft.

BC203 Some respondents expressed concern that the criteria for when revenue should be constrained would require an entity to recognise revenue when factors outside the entity's control could subsequently affect the amount of revenue recognised. For instance, with many sales-based royalties, an entity's performance occurs at the beginning of the contract, but the amount of consideration is based on the customer's subsequent sales of goods or services. In those cases, both users and preparers thought that it would not be useful for an entity to recognise revenue at the inception of the contract for the total amount of the consideration to which the entity expects to be entitled. That is because that approach inevitably would require the entity to report, throughout the life of the contract, significant adjustments to the amount of revenue recognised at inception of the contract as a result of changes in circumstances. For those contracts, users and preparers explained that the most useful information would be to recognise revenue when there is no longer uncertainty about the amount of consideration to which the entity is entitled. To address those concerns, the boards decided that for the circumstances described in paragraph 85 an entity should not recognise revenue for the uncertain amounts until the uncertainty is resolved (ie when the customer's subsequent sales occur). However, the boards emphasised that paragraph 85 would not preclude an entity from recognising revenue in *all* circumstances in which factors outside the entity's influence exist. Thus, for circumstances other than those in paragraph 85, an entity should consider the indicators in paragraph 82 to determine the amount of consideration to which the entity is reasonably assured to be entitled.

Appendix B: Extracts of the Leases project regarding the accounting for variable payments

Effects of the Board redeliberations on the exposure-draft Leases

At their 16 February 2011 meeting the boards tentatively decided that:

(a) The lessee's liability and lessor's receivable should include:
i. lease payments that depend on an index or rate;
ii. lease payments for which the variability lacks commercial substance; and
iii. lease payments that meet a high recognition threshold (such as reasonably certain).

(b) Variable lease payments that depend on an index or a rate should be measured initially based on the spot rate.

(c) Recognition of variable lease payments by a lessee and lessor should be subject to the same reliable measurement threshold. However, the need for such a threshold will depend on the basis for recognising variable lease payments.

Having considered the feedback received and additional staff analysis, at their April 2011 meeting the boards:

(a) confirmed that the measurement of the lessee's liability and the lessor's receivable should include lease payments that are in-substance fixed lease payments but are structured as variable lease payments in form.

(b) changed their tentative decision in relation to lease payments that meet a high threshold and decided that in such cases (ie when the payments are less certain) those amounts should not be included in the measurement of the lessee's liability and the lessor's receivable.

The boards will discuss lease payments that depend on an index or a rate, including reassessment, at a future meeting. In addition, the boards asked the staff to consider appropriate disclosures for variable lease payments for future discussions.

At their 20 July 2011 meeting the boards discussed the measurement of lease payments that depend on an index or on a rate that is included in the lessee's liability to make lease payments and the lessor's right to receive lease payments and tentatively decided that:

(a) Lease payments that depend on an index or a rate should be measured initially using the index or rate that exists at the date of commencement of the lease.

(b) Lease payments that depend on an index or a rate should be reassessed using the index or rate that exists at the end of each reporting period.

(c) Lessees should reflect changes in the measurement of lease payments that depend on an index or a rate (a) in net income to the extent that those changes relate to the current reporting period and (b) as an adjustment to the right-of-use asset to the extent that those changes relate to future reporting periods.

The boards will discuss at a future meeting how a lessor should reflect changes in the measurement of lease payments that depend on an index or a rate.