IFRS 9, IFRS 15 and IAS 16: Seller's Right to Variable Consideration in an Asset Sale

Extract, IFRS Discussion Group Report on the Meeting – May 30, 2017

At its September 11, 2014 meeting, the Group discussed "IFRS 3, IFRS 15, IAS 18 and IAS 37: Contingent Consideration in an Asset Sale" which focused mainly on the recognition and measurement of contingent consideration.

In this meeting's discussion, the Group will consider the same fact pattern with some added details, taking into account the timing of derecognition, initial recognition and measurement of variable consideration, related balance sheet accounting, and subsequent accounting with respect to IFRS 15 *Revenue from Contracts with Customers* and IFRS 9 *Financial Instruments*.

Fact Pattern

Entity A sells one or more assets that do not constitute a business to Entity B. The assets are property, plant and equipment that will be accounted for in accordance with IAS 16 *Property, Plant and Equipment.* Entity B pays Entity A cash consideration at the time of the purchase and agrees to pay additional amounts in one year's time based on a combination of factors, including whether Entity B is able to achieve specified production milestones with the assets. Entity A is not in the business of selling items of property, plant and equipment (i.e., this transaction is not in the normal course of business). Entity A has no further performance obligations once the transfer of title and delivery has occurred.

The nature of the variable consideration in this transaction does not give rise to an embedded derivative (i.e., it is based on Entity B obtaining production of 100 units). The variable consideration is due in one year's time; therefore, no significant financing component is identified. The disposal is not a sale and leaseback transaction.

Issue 1: Is the timing of derecognition of property, plant and equipment different under IFRS 15 compared to IAS 18* Revenue*?

IAS 16 requires that the gain or loss arising from derecognition of an item of property, plant and equipment is included in profit or loss when the item is derecognized. It also requires the criteria in IAS 18 to be applied for recognizing revenue from the sale of goods.

Paragraph 14 of IAS 18 provides conditions that have to be satisfied for the recognition of revenue (i.e., the date of derecognition for the asset). For example, an entity needs to assess when the significant risks and rewards of ownership have transferred, determine if it retains continuing managerial involvement in the asset, and assess whether the sale proceeds can be measured reliably. Upon transition to IFRS 15, this cross-reference to IAS 18 in IAS 16 changes to IFRS 15, and therefore, focuses on the notion of control.

Control refers to the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. The notion of continuing managerial involvement does not exist in IFRS 15, at least in terms of assessing when control transfers. The control model in IFRS 15 may affect the timing of derecognition of the asset compared to the risks-and-rewards model in IAS 18.

The Group's Discussion

The Group welcomed to the discussion the Canadian member of the IASB/FASB Joint Transition Resource Group for Revenue Recognition.

Group members agreed that in some situations applying the concept of control under IFRS 15, instead of the concept of significant risks and rewards of ownership under IAS 18, could lead to different timing of derecognition of property, plant and equipment. This result may be a lesser known consequence arising upon application of the new standard.

Issue 2: If the criteria for derecognition of property, plant and equipment are met, how should Entity A (i.e., the seller) initially measure the consideration received (or receivable) to determine the gain or loss on sale?

View 2A – The seller's right to variable consideration should be measured with reference to the IFRS 15 guidance on the transaction price and recognized as part of the proceeds on sale of the asset on transfer of control.

Prior to IFRS 15, paragraph 72 of IAS 16 indicates that consideration receivable on the disposal of an item of property, plant and equipment is recognized at fair value. Under IFRS 15, paragraph 72 of IAS 16 is amended to state that the consideration is determined in accordance with the requirements for determining the transaction price in paragraphs 47 to 72 of IFRS 15.

Paragraph 56 of IFRS 15 requires the transaction price to include some or all of an amount of variable consideration estimated in accordance with paragraph 53 of IFRS 15. The inclusion of variable consideration occurs if it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved (i.e., the variable consideration constraint). The assessment is updated at each reporting period.

If the consideration is variable, an entity must estimate the amount using either the "expected value" or "most likely method" under IFRS 15. An inability or difficulty in measuring the transaction price due to variability is not a reason to not recognize revenue. A certain amount of variable consideration may be estimated in the transaction price, subject to the constraint requirement.

In contrast to IAS 18, the constraint requirement in IFRS 15 may result in the consideration initially being measured at an amount lower than fair value, resulting in a corresponding decrease in any gain (or increase in loss). However, if an entity did not previously recognize variable consideration until the contingencies were resolved, the introduction of IFRS 15 could result in an increase in the transaction price and a higher gain on sale (or decreased loss). There could be a transition adjustment on the adoption of IFRS 15 if the contingencies have not been resolved.

View 2B – The seller's right to variable consideration should be recognized and measured at some other point (for example, when the conditions associated with the variability are met and amounts are receivable).

This view is consistent with View B in the Group's September 11, 2014 discussion on the issue "IFRS 3, IFRS 15, IAS 18 and IAS 37: Contingent Consideration in an Asset Sale." That is, variable consideration is similar to a contingent asset, which should not be recognized in accordance with paragraph 31 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

In addition, in 2013, the IASB considered an IFRS Interpretations Committee paper titled "Variable Payments for the Separate Acquisition of Property, Plant and Equipment and Intangible Assets." Two alternatives were put forward in that paper. One alternative was similar to View 2A above, but contemplated from a buyer's perspective. The other alternative held that contingent consideration payments that are dependent on actions of the buyer do not meet the definition of a financial liability until those actions are performed. Proponents of View 2B may analogize to the latter alternative and conclude that if the buyer does not have a liability, then the seller does not have an asset. However, in March 2016, the IFRS Interpretations Committee observed significant diversity in practice in the accounting for variable payments by the purchaser and determined that the issue was too broad for it to address within the confines of existing standards.

The Group's Discussion

Group members supported that the seller's right to variable consideration should be measured with reference to the IFRS 15 guidance on the transaction price and recognized as part of the proceeds on sale of the asset on transfer of control (View 2A). They noted the importance of using professional judgment to apply the estimation techniques in IFRS 15 to determine the amount of variable consideration.

One Group member also emphasized the importance of considering the type of variability relating to the consideration. Another Group member observed that, as a means to strike an agreement, an entity often promises consideration in a contract with a customer that can vary if the entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event.

One Group member noted the variability in IFRS 15 is associated with the seller's performance (i.e., a performance or incentive bonus), the quality of goods that have been sold (i.e., the goods performing as promised) or possible actions by the buyer (i.e., returns). Therefore, this Group member thought that it was important to determine whether the variability associated with this issue is the type contemplated within the scope of IFRS 15. This Group member also questioned whether, upon transition, the practical expedient in paragraph C5(a)(ii) of IFRS 15 for completed contracts would be available for contracts when control had transferred and the variable consideration remains unresolved at the date of initial application of IFRS 15.

Issue 3: If the criteria for derecognition of property, plant and equipment are met and the transaction price (proceeds on sale) includes variable consideration (i.e., View 2A), what should Entity A initially recognize in the Statement of Financial Position?

View 3A – The variable consideration is recognized as a contract asset and is initially measured in accordance with IFRS 15.

When an entity satisfies its performance obligation before receiving payment, the entity has a contract asset. IFRS 15 defines a contract asset as an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time.

Proponents of this view look to paragraph BC323 in the Basis for Conclusions on IFRS 15, which states, in part, the following:

> "In many cases, that contract asset is an unconditional right to consideration—a receivable—because only the passage of time is required before payment of that consideration is due. However, in other cases, an entity satisfies a performance obligation but does not have an unconditional right to consideration, for example, because it first needs to satisfy another performance obligation in the contract. The boards decided that when an entity satisfies a performance obligation but does not have an unconditional right to consideration, an entity should recognise a contract asset in accordance with IFRS 15."

Entity A has transferred control of the property, plant and equipment but there is no unconditional right to the variable consideration because Entity B must meet production milestones. The variable consideration is initially recognized at the amount determined in accordance with IFRS 15 because paragraph 2.1(j) of IFRS 9 excludes contract assets from its scope.

View 3B – The variable consideration is recognized as a financial asset (i.e., receivable) and is initially measured in accordance with IFRS 9.

Paragraph AG8 of IAS 32 *Financial Instruments: Presentation* indicates that a contingent right meets the definition of a financial asset, even though such assets are not always recognized in the financial statements.

As the financial asset is initially measured at fair value in accordance with paragraph 5.1.1 of IFRS 9, a day 1 gain or loss would arise on the recognition of the variable consideration. The reason is that the transaction price is determined under IFRS 15, which may not be representative of fair value due to the variable consideration constraint. Paragraph B5.1.2A of IFRS 9 provides guidance on whether the day 1 gain or loss should be recognized immediately into profit or loss.

The Group's Discussion

Group members supported recognizing the variable consideration as a contract asset that is initially measured in accordance with IFRS 15 (View 3A). One Group member noted that once a transaction with a customer is considered to give rise to a contract asset, the contract asset remains until the uncertainty is resolved.

Issue 4(a): If Entity A has initially recognized an amount for variable consideration as a contract asset (i.e., View 3A), how should Entity A subsequently measure the variable consideration?

Paragraph 72 of IAS 16 (as amended by IFRS 15) explicitly states that subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in IFRS 15.

Paragraph 59 of IFRS 15 requires an entity to reassess, at the end of each reporting period, the estimate of the transaction price, including a reassessment of whether an estimate of variable consideration is constrained. The changes in transaction price are recognized in accordance with paragraphs 87 to 89 of IFRS 15 in the period in which the transaction price changes.

The contract asset would be subject to impairment requirements of IFRS 9 based on paragraph 107 of IFRS 15.

Once Entity A has an unconditional right to consideration, it should present that right as a receivable separately from the contract asset and account for it in accordance with IFRS 9. Entity A would have an unconditional right once Entity B meets all of the production milestones. At this point, Entity A would derecognize the contract asset and recognize a financial asset.

Paragraph 108 of IFRS 15 states, in part, that “upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with IFRS 9 and the corresponding amount of revenue recognised shall be presented as an expense (for example, as an impairment loss).”

Issue 4(b): If Entity A has initially recognized an amount for variable consideration as a financial asset (i.e., View 3B), how should Entity A subsequently measure the receivable?

Subsequent accounting for the variable consideration is in accordance with IFRS 9 because it is viewed as a financial asset.

Assuming that the business model of Entity A is “held-to-collect”, the entity would need to assess whether the contingent receivable’s contractual cash flows are solely principal and interest. For an instrument to meet the solely principal and interest criterion, the guidance in paragraphs 4.1.2(b) and B4.1.7A of IFRS 9 should be considered. Furthermore, paragraph B4.1.10 of IFRS 9 states, in part, the following:

> “If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, if the asset can be prepaid before maturity or its term can be extended), the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are solely payments of principal and interest on the principal amount outstanding. To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (ie the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator.”

Paragraph B4.1.18 of IFRS 9 also provides guidance on when contractual terms can be ignored for classification.

If the solely principal and interest criterion is not met, Entity A is required to measure the variable consideration at fair value. The nature of the contingencies may be a determining factor in whether the solely principal and interest criterion is met and whether the asset is subsequently measured at amortized cost or fair value. The guidance in IFRS 3 *Business Combinations* which requires contingent consideration to be measured at fair value may also be considered.

The Group's Discussion

The Group considered both Issues 4(a) and 4(b) together.

Group members supported the subsequent accounting treatment of the variable consideration as described under Issue 4(a).

The Group did not further contemplate the subsequent accounting treatment under Issue 4(b) given that for this fact pattern, the Group's view is the variable consideration should be accounted for as a contract asset (i.e., View 3A).

The Canadian member of the IASB/FASB Joint Transition Resource Group for Revenue Recognition emphasized the importance of using the terminology inherent in IFRS 15 in discussing issues about revenue (for example, referring to variable consideration, rather than contingent consideration). She explained that the new model in IFRS 15 requires completely different thinking than under IAS 18.

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).