Project **Revenue Recognition**

Topic **Onerous performance obligations**

Purpose

1. In the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* the Boards proposed that a performance obligation should be remeasured when it is deemed onerous—ie when the expected costs of satisfying the performance obligation exceed its carrying amount.

2. In the light of responses to the Discussion Paper, the purpose of this paper is:

   (a) to reconsider whether the revenue standard should include an onerous test (paragraphs 7–15); and

   (b) if the revenue standard includes an onerous test, to decide:

      (i) at what unit of account the test should operate (paragraphs 16–30);

      (ii) which costs to include in the onerous test and in remeasuring onerous performance obligations (paragraphs 31–41); and

      (iii) the subsequent accounting for onerous performance obligations, including reporting the effects of the remeasurements (paragraphs 42–47).

Summary of recommendations

3. This paper recommends that:

   (a) The Boards reaffirm their preliminary view that the revenue recognition standard should include an onerous test for performance obligations.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

(b) An entity should conduct the onerous test at the level of contract segments.

(c) A contract segment is onerous if the expected costs to satisfy the remaining performance obligations in that segment exceed the amount of the transaction price allocated to those performance obligations.

(d) An entity should recognise a liability and a corresponding contract loss for an onerous contract segment in the amount by which the expected costs to satisfy the remaining performance obligations in that contract segment exceed the amount of the transaction price allocated to those performance obligations.

(e) At each subsequent financial statement date, an entity should update the liability for the onerous segment (ie to the amount by which the expected costs to satisfy the remaining performance obligations in the contract segment at that date exceed the amount of the transaction price allocated to those performance obligations).

(f) For the onerous test and remeasurement, costs are the direct or incremental costs, ie all costs that relate directly to the specific contract or that would not have been incurred without entering into the contract.

Background

4. The Discussion Paper proposed that:

(a) after contract inception, a performance obligation should be remeasured when onerous.

(b) a performance obligation is onerous when an entity's expected cost of satisfying the performance obligation exceeds the carrying amount of that performance obligation.

(c) an entity would remeasure an onerous performance obligation to its expected cost of satisfying the performance obligation and recognise a corresponding contract loss.

5. Because the remeasurement would not affect the amount of revenue recognised when the performance obligation is satisfied, the Discussion Paper implied that an entity would recognise a separate liability for the effects of the remeasurement.

6. The Discussion Paper did not specify:

   (a) which costs should be included in the onerous test and in the remeasurement of an onerous performance obligation;

   (b) at what unit of account the test should operate (eg a single performance obligation, the remaining performance obligations in a contract or a portfolio of homogeneous performance obligations); and

   (c) the subsequent accounting for an onerous performance obligation.

Should the revenue standard include an onerous test?

Feedback from respondents

7. Almost all respondents agreed that the proposed revenue recognition model requires an onerous test. Only a handful of respondents supported an approach in which there would be no remeasurement of performance obligations. Those respondents thought that losses on a contract should just emerge over time as the revenue is recognised.

8. Of those respondents who supported an onerous test, some thought the test should not be included in the revenue recognition standard. Respondents noted that:

   (a) the proposed onerous test is unrelated to the recognition and measurement of *revenue* and, hence, the accounting for a performance obligation. For instance PricewaterhouseCoopers argued that the 'recognition of an onerous contract provision is an accrual of costs and not a performance obligation'.

   (b) articulating the onerous test as a remeasurement of a performance obligation introduces an exception into the model. In an allocation model,

a performance obligation should be adjusted only if the transaction price changes. Respondents underscored this point by observing that the proposed basis of remeasurement in the onerous test is different from the initial measurement.

> When a contract is deemed onerous, the DP makes an exception to the original transaction price measurement approach … In this limited case, the DP proposed to remeasure the performance obligations. We suggest this exception could be eliminated by recognising a separate liability rather than remeasuring the performance obligations. (Accounting Standards Board of Japan)

(c) the accounting for onerous contracts with customers would be different from the accounting for other onerous contracts.

> [W]e do not believe that there can be two measurement principles for onerous contracts; one in the new revenue recognition standard and one in the new liability standard [ie revised IAS 37]. The principles have to be the same. (Danish Accounting Standards Committee)

9. Most of those respondents think the Boards should leave the onerous test to existing standards, ie FASB Accounting Standards Codification (ASC) Topic 450 *Contingencies* (formerly FAS 5 *Accounting for Contingencies*) and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

> Remeasurement for onerous contracts should be in accordance with existing liability recognition and measurement standards. It would seem inconsistent to have performance obligations remeasured in accordance with a cost trigger, but other liabilities remeasured in accordance with the requirements of IAS 37, bearing in mind ongoing discussion on non-financial liabilities, and FAS 5. We recommend that the boundary of the revenue recognition standard be the allocation of the transaction price, and that remeasurement be addressed by the existing standards. (Ernst & Young)

Consequences of leaving the onerous test to other standards

10. In the light of feedback from respondents, the Boards could decide to amend their preliminary view and not include an onerous test in the proposed revenue recognition model. Instead, they could leave the onerous test to existing standards. The main consequences would be as follows:

(a) The accounting for onerous performance obligations in US GAAP and IFRSs would differ because of the different requirements of ASC Topic

450 and IAS 37. Although those differences would not affect revenue, they would affect the margin reported on contracts.

(b) The accounting for onerous contracts with customers in IFRSs would be consistent with the accounting for other onerous contracts.

(c) Unlike IFRSs, US GAAP does not have an explicit general onerous test, although practice looks to ASC Topic 450. (There are specific requirements for construction contracts in ASC Subtopic 605-35 *Construction-Type and Production-Type Contracts* similar to those in IAS 11 *Construction Contracts*, but both of those requirements would be withdrawn as a result of the project.) Practice in US GAAP therefore might vary in how entities account for onerous performance obligations.

(d) The measurement basis for an onerous test in the proposed revised IAS 37 would differ from the cost basis proposed in the Discussion Paper (the difference is illustrated in the Appendix to this paper). The proposed measurement in IAS 37 is the *value* of the outflows required to fulfil the obligation and, hence, includes a margin. That would also be different from the current requirements for onerous construction contracts in IAS 11 and, based on the comment letters, current practice for other sales contract under IAS 37. Respondents to the Discussion Paper overwhelmingly agreed with the Boards' preliminary view that the basis of remeasurement should be cost and not current price/value. For instance:

> The AASB considers that, in the context of conventional (modified historical cost) accounting, the proposed treatment is consistent with the measurement of items at the transaction price until any impairment occurs. The AASB supports using the entity's expected cost of satisfying the performance obligation to determine whether that obligation is onerous because …adding a margin is more consistent with using a current value basis to measure performance obligations. (Australian Accounting Standards Board)

> We do not agree with the Board's interpretation and repeated assertion in the DP that the best estimate of expected cost under IAS 37 includes a margin. In our view, IAS 37 does not require inclusion of a margin for settlement. (BP)

(e) The Boards would have to describe what the liability recognised for an onerous contract represents. Some argue that that liability must relate to

the accounting for performance obligations because no new liability is incurred as a result of performance obligations becoming onerous. In other words, there is no new obligating event when a contract becomes onerous, only a remeasurement event.

Staff recommendation

11. The staff thinks that for IASB members this issue largely rests on whether they think onerous performance obligations in IFRSs should be measured consistently with:
    (a) onerous performance obligations in US GAAP; or
    (b) other onerous contracts in the scope of IAS 37.
12. In particular, if IASB members wish to maintain their preliminary view in the Discussion Paper of a cost remeasurement for onerous performance obligations, they cannot leave the onerous test to the proposed revised IAS 37 (and ultimately will need to exclude onerous contracts with customers from the scope of the revised IAS 37). As noted above, almost all respondents agreed with the cost remeasurement proposed in the Discussion Paper and other feedback from respondents has not highlighted any issues that the Boards did not consider in making that decision. In addition, the staff has also spoken to some users on this specific point and most seem to think that it would be confusing if, after remeasuring onerous performance obligations, an entity were subsequently to recognise a profit on satisfying those performance obligations.
13. For FASB members, this issue largely rests on whether they think the requirements of ASC Topic 450 are sufficiently clear to result in consistent accounting for onerous performance obligations.
14. Given that context, and the desire to maintain (as far as possible) consistency of accounting between IFRSs and US GAAP for contracts with customers (subject only to legacy differences in accounting for costs), the staff thinks that the revenue recognition standard should address onerous contracts with customers.

15. Consequently, the remainder of this paper considers the additional issues that the Boards need to consider with respect to the onerous test proposed in the Discussion Paper.

Question 1 Whether to include an onerous test in the revenue standard
The staff recommends that the Boards reaffirm their preliminary view that the revenue recognition standard should include an onerous test for performance obligations. Do the Boards agree?

At what unit of account should the onerous test operate?

16. If the Boards develop the onerous test in the revenue recognition standard, they need to decide at what unit of account the test should operate. That decision affects whether performance obligations are deemed onerous and, hence, when the performance obligations in the contract are remeasured.

17. There are three options for the Boards to consider:

    (a) performance obligation, or

    (b) contract, or

    (c) segment.

Performance obligation

18. With this option, the entity would test whether the expected costs to satisfy an individual performance obligation exceed the amount of the transaction price allocated to that performance obligation.

19. Most respondents thought that the Boards were proposing this option in the Discussion Paper and disagreed with it. They noted that this option could result in a contract loss being recognised for a contract that, considered as a whole, is profitable.

20. The consequences of this option are:

    (a) It would be more sensitive to changes in circumstances after contract inception than the other options discussed below.

(b) It would be impracticable, particularly in continuous-delivery contracts in which there are, in principle, countless performance obligations (eg construction contracts).

Contract

21. With this option, the entity would test whether the expected costs to satisfy all the remaining performance obligations in the contract exceed the transaction price allocated to those performance obligations.

22. Many respondents, particularly construction companies, argued that the onerous test should be applied at the level of the contract. By that they meant that an entity should recognise a contract loss only if the contract *as a whole* is loss making, ie if the total cost to satisfy *all* performance obligations exceeds the transaction price. That would be similar to the onerous test in ASC Subtopic 605-35 and IAS 11 (ie the treatment of 'anticipated losses' and 'expected losses'). Those respondents argue that entities manage the margin at the contract level, so that a loss on one part of a contract is mitigated by profit in other parts of the contract.

23. However, to be consistent with the proposed model, in this option the *remaining* performance obligations would be tested to identify whether they are onerous. In other words, the onerous test would be viewed as the mirror image of an asset impairment test: just as assets are tested to ensure that they are not overstated, so the performance obligations in the contract are tested to ensure that they are not understated.

24. The consequences of this option are:

(a) It could delay reporting changes in adverse circumstances: the remaining performance obligations in the contract are not remeasured until all the remaining margin in the contract is exhausted. Consider the following:

> An entity enters into a contract on 1 January with two segments, A and B. All the performance obligations in A will be satisfied on 30 June, all the performance obligation in B on 31 December.

> The transaction price allocated to A and B is CU8,000 and CU12,000 respectively and the expected costs to satisfy A and B at 1 January are CU5,000 and CU10,000 respectively.
>
> Suppose that on 31 March, the expected costs on B increase to CU13,000. Because the expected costs to satisfy the remaining performance obligations (CU18,000) do not exceed the transaction price allocated to those obligations (CU20,000), the remaining performance obligations are not onerous. Assuming that there are no further changes in circumstances, the remaining performance obligations would be onerous and remeasured only after the entity satisfies the performance obligations in segment A.

(b) It is arguably inconsistent with the proposed model. The model aims to reveal the different margins on different parts of the contract. Allowing changes in circumstances on one part of a contract to be absorbed by other parts of the contract seems inconsistent with that objective.

Segment

25. With this option, the entity would test whether the expected costs to satisfy the remaining performance obligations in a segment of the contract exceed the amount of the transaction price allocated to those performance obligations.

26. The difference from the contract option is that adverse changes in circumstances in one segment of a contract are recognised as soon as they result in that segment being onerous. They are not offset against the margin in other segments of the contract. Consider again the example in paragraph 24: with the segment option, segment B is onerous on 31 March rather than 30 June as with the contract option.

27. The consequences of this option are:

(a) It is the most practical option below the level of the contract, because the unit of account for the onerous test would be the same as the unit of account for allocating the transaction price.

(b) It is arguably the option most consistent with the Boards' proposed model (a view shared by some respondents who argued that the unit of account

for the onerous test should be the same as the unit of account for allocation).

(c) Although this option is at a higher unit of account than the individual performance obligation, many constituents would probably still object to it, because a contract loss could be recognised for a segment, even though the contract as a whole remains profitable. However, it should be noted that:

(i) the onerous test for construction contracts in existing standards is applied to any separately identified segments of the contract (although those segments would likely be at a higher level than in the proposed model);

(ii) although IAS 37 articulates the onerous test at the contract level,[1] an interpretation of that test in IFRIC 13 *Customer Loyalty Programmes* applies the test only to the loyalty programme segment of the contract, not the whole contract. This suggests that in practice IAS 37 is not always applied at the contract level.

Other considerations

28. Some respondents argued that the onerous test, in some cases, should be applied to a portfolio of segments (eg a portfolio of warranties) because those segments are priced and managed as a portfolio. In other words, in pricing the contract the entity expects that a proportion of the segments will become onerous, but that the losses on those segments will be subsidised by the profits on similar segments in other contracts.

29. The staff thinks this problem is largely resolved by clarifying that the expected costs to satisfy the remaining performance obligations reflect all possible outcomes.

---

[1] IAS 37, paragraph 10: 'An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it'.

Staff recommendation

30. Because of the impracticability of applying the onerous test at the performance obligation level, the staff thinks that the choice for the Boards is between the contract or segment levels. Of these two options, the staff recommends the segment level because, as noted above, the segment seems most consistent with the proposed model.

Question 2 Unit of account for the onerous test
The staff recommends that an entity should conduct the onerous test at the level of contract segments. Accordingly a contract segment is onerous if the expected costs to satisfy the remaining performance obligations in that segment exceed the amount of the transaction price allocated to those performance obligations. Do the Boards agree?

What costs should be included in the onerous test and the remeasurement?

31. The staff thinks that there are two main options for the Boards to consider as a definition of cost for the onerous test (ie for determining when the remaining performance obligation should be remeasured) and remeasurement (ie for determining the amount of the remeasurement):

    (a) full cost, or

    (b) direct or incremental cost.

Full cost

32. Under the full-cost approach, the entity would include all costs associated with satisfying the performance obligations in the contract segment. Those costs would include:

    (a) all costs that relate directly to the specific contract (eg direct materials, labour, subcontractor costs);

(b) an allocation of costs that relate to the entity's contract activities in general (eg contract management, technical assistance and supplies); and

(c) an allocation of the entity's general and administrative costs.

33. In support of a full-cost approach it could be argued that:

(a) The remeasurement would be reasonably consistent with the costs implicit in the initial measurement of the performance obligation, because an entity would be expected to recover all of the costs listed in paragraph 32 in its selling price.

(b) The remeasurement would largely be independent of an entity's cost structure thus enhancing the comparability of the remeasurements relative to the direct or incremental-cost approach. (Note, however, that 'cost' will vary between entities depending on the extent to which they use subcontractors.)

34. This definition of cost would be similar to that included in ASC Subtopic 605-35 and IAS 11 and that is used for determining whether there is an expected loss on a construction contract (although those standards exclude 'general administration costs' unless they are specifically chargeable to the customer under the terms of the contract).

Direct or incremental cost

35. Under a direct or incremental-cost approach, the entity would include the direct or incremental costs associated with satisfying the performance obligations in the contract segment. Those costs would include:

(a) all direct costs, ie those costs that relate directly to the specific contract (eg direct materials, labour, subcontractor costs); and

(b) other costs that would not have been incurred without that contract.

36. In support of a direct or incremental-cost approach it could be argued that:

(a) The onerous remeasurement would exclude costs that the entity would incur regardless of the contract (ie any costs that are not directly

attributable to the specific contract). Some argue that it is not appropriate to include such costs in the onerous liability because these costs are not avoidable: the entity would have incurred them regardless of the contract. Hence, they argue that if such costs are included, the entity is accelerating the recognition of expenses that should be recognised as incurred.[2]

(b) In the absence of specifying a value or a price for the remeasurement, the direct or incremental-cost approach provides a clearer objective than the full-cost approach for which costs should be included. It therefore avoids some of the difficulties associated with determining which costs are allocable under the full-cost approach.

Other considerations

37. The expected costs, however defined, should reflect the range of possible outcomes, ie they should be the probability-weighted costs. However, should the onerous test and remeasurement include an adjustment for risk?

38. Current standards view risk as a component of a measurement based on price (eg the price that market participants would charge to assume the uncertainty in expected cash flows) or value (eg the value to the entity of not having to bear the uncertainty in the expected cash outflows). It is not clear how an adjustment for risk could be included as part of a cost measurement.

39. Therefore, the staff does not recommend including adjustments for risk in the onerous test and in the remeasurement.

Staff recommendation

40. Of the two options, the full-cost approach seems most consistent with the notion of remeasuring a performance obligation. However, the staff acknowledges that many do not view the onerous test as a remeasurement of performance obligations. Rather, they view it as recognising an expected loss on the contract

[2] For example, 'costs that are not incremental should not be considered in the onerous contract analysis as they are costs to operate the business' (KPMG *Insights into IFRS,* 5th Edition, page 699).

or segment of the contract. Indeed, that view point is supported by the Boards' decision to remeasure the performance obligation at cost and, therefore, differently from the initial measurement. And because of that context, many are concerned about an entity accruing future operating costs that would have been incurred even if the contract had not been entered into.

41. Therefore, for the reasons discussed in paragraph 36, the staff recommends the direct or incremental-cost approach.

Question 3 Definition of cost for the onerous test and remeasurement
The staff recommends that for the onerous test and remeasurement, costs are the direct or incremental costs, ie all costs that relate directly to the specific contract or that would not have been incurred without entering into the contract. Do the Boards agree?

Subsequent accounting for an onerous performance obligation, including reporting the effects of the remeasurements

42. Once a contract segment has become onerous and the remaining performance obligations in the segment are remeasured, the staff thinks that the revenue standard needs to provide guidance on the subsequent accounting for that onerous contract segment.

Are the onerous performance obligations subsequently updated?

43. Once a contract segment is onerous, the staff thinks that the remaining performance obligations should be updated at each financial statement date. That is because once a segment is onerous, there is no margin remaining in that segment to absorb further adverse changes in circumstances. Hence, any additional increase in the remaining expected costs should be recognised as an additional contract loss. Similarly, if the expected costs to satisfy the performance obligations in the segment decrease, there seems to be no reason why the entity should not reduce or ultimately reverse the effects of the remeasurement. As one respondent noted:

> Failure to reverse previously recognised onerous provisions where it is clear that contracts have ceased to be onerous would not provide decision useful information at each balance sheet date. (Sappi)

How are the effects of the remeasurement reported?

44. The Discussion Paper proposed that when an entity remeasures onerous performance obligations, it should recognise the remeasurement in profit or loss as a contract loss, ie the remeasurement does not affect revenue.

45. The Discussion Paper was less clear on how the effects of the remeasurement would be reflected in profit or loss when the remeasured performance obligations are satisfied. Although the Boards explained that the amount of revenue recognised is the amount of the transaction price, some respondents were concerned that that the *remeasured* amount of the performance obligation would be recognised as revenue, not the amount initially allocated to the performance obligation.

46. Because the remeasurement would need to be tracked separately for the purposes of reporting its effects in profit or loss separately from revenue, the staff thinks that it would be clearer if the Boards specified that the remeasurement is recognised as a separate liability. That would be consistent with existing standards and practice, and would avoid any confusion that might lead to the misconception that the remeasurement and its subsequent accounting affect revenue.

47. Consistently with paragraph 43, the practical effect of recognising a separate liability is that the entity would update the measurement of that liability. At each financial statement date the entity would adjust the liability to the amount by which the expected costs to satisfy the remaining performance obligations in the segment at that date exceed the amount of the transaction price allocated to those performance obligations.

Staff recommendations

Question 4 Subsequent accounting of an onerous performance obligation and reporting the effects of remeasurement
The staff recommends that: (a) an entity recognises a liability and a corresponding contract loss for an onerous segment in the amount by which the costs to satisfy the remaining performance obligations in that segment exceed the amount of the transaction price allocated to those performance obligations. (b) at each subsequent financial statement date, the liability for the onerous segment is updated (ie to the amount by which the expected costs to satisfy the remaining performance obligations in the segment at that date exceed the amount of the transaction price allocated to those performance obligations). Do the Boards agree?

Appendix

A1. This Appendix illustrates how remeasuring performance obligations in the proposed revised IAS 37 would differ from the cost basis proposed in the Discussion Paper.

> Entity enters into a contract to sell goods for CU100 and expects the production costs to be CU80. Subsequently circumstances change and the entity's expected production costs increase by CU30. Suppose Entity would also now have priced the contract at CU130.
>
> The contract is onerous.

If the performance obligations are remeasured by reference to cost

A2. Entity recognises a liability and contract loss for the amount by which the revised expected costs (CU110) exceed the CU100 allocated to the performance obligations, ie CU10.

A3. When Entity transfers the goods to the customer, it recognises no profit or loss (ie revenue of CU100, less costs of CU110 plus reversal of liability of CU10).

If the performance obligations are remeasured by reference to value

A4. Entity recognises a liability and contract loss for the amount by which the value of the goods it has promised to transfer to the customer (CU130) exceeds the CU100 allocated to the performance obligations, ie CU30.

A5. When Entity transfers the goods to the customer, it recognises profit of CU20 (ie revenue of CU100, less costs of CU110 plus reversal of remeasurement of CU30).