IFRS

FASB

IASB/FASB Meeting February 2011

IASB Agenda reference **4G**

FASB Agenda reference **137G**

Staff Paper

Project **Revenue Recognition**

Topic **Onerous performance obligations**

Purpose of this paper

1. The purpose of this paper is to reconsider the following issues related to the onerous test:
   (a) the unit of account to which the onerous test should be applied (paragraphs 11-36); and
   (b) the costs to include in the onerous test and in measuring an onerous liability (paragraphs 37-51).
2. Various parts of the revenue recognition model interact with the onerous test, including:
   (a) identifying separate performance obligations;
   (b) allocating the transaction price and contract discounts, and
   (c) constraining estimates of variable consideration.
3. The interaction of these issues with the onerous test is outlined in paragraph 15 of this paper. However, this paper does not request decisions from the Boards on those issues. The Boards discussed the issue of identifying separate performance obligations in January and further analysis is presented in paper 4A/137A. The other issues will be presented to the Boards separately for redeliberation next

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month. The staff believes that the Boards can reach a tentative decision on the application of the onerous test without waiting for future discussions of these issues.

Summary of recommendations

4. The staff recommends that an entity should conduct the onerous test at the level of the remaining performance obligations in the contract. However, an entity should not recognise an onerous liability on entering into a contract if the entity:
   (a) expects to recover the loss on that contract through subsequent contracts that are functionally linked with the loss-making contract; and
   (b) has sufficient relevant experience to determine that it will obtain those subsequent contracts.
5. For the onerous test and measurement of the onerous liability, the staff recommends that costs are the lower of:
   (a) the costs that relate directly to the contract (as proposed in the exposure draft), and
   (b) any amounts the entity would have to pay to cancel the contract (eg the amount it would have to refund the customer, including any penalties).

Background

6. In the exposure draft *Revenue from Contracts with Customers* the Boards proposed that an onerous test should be included in the revenue recognition model. This is because the test 'is a necessary component of a revenue recognition model in which the initial measurements of performance obligations are not routinely updated'[1] to ensure that those performance obligations are not understated[2].

[1] paragraph BC134.
[2] paragraph BC133(b).

7. The exposure draft proposed that:

> a performance obligation is onerous if the present value of the probability-weighted[3] costs that relate directly to satisfying that performance obligation...exceeds the amount of the transaction price allocated to that performance obligation. (paragraph 55)

8. When a performance obligation is onerous, the exposure draft proposed that an entity should recognise a liability and a corresponding expense.

9. The Boards' rationale for requiring entities to conduct the onerous test using performance obligations as the unit of account is that it would provide:

   (a) transparency for margins on each performance obligation. Transparency is achieved because margins on loss-making performance obligations will not be offset against margins on other profitable performance obligations. This is consistent with the objective of identifying separate performance obligations.

   (b) timely information by recognising 'adverse changes in circumstances affecting a separate performance obligation as soon as they result in that separate performance obligations being loss-making' (paragraph BC136).

10. Question 9 of the exposure draft requested respondents' views on the costs to be included in the onerous test. Although no other questions were asked about the onerous test, many respondents included comments on the application of the onerous test in their response.

Unit of account

Feedback from respondents

11. Almost all of the respondents who commented on this proposal objected to applying the onerous test at the unit of account of the performance obligation.

[3] The Boards are separately considering probability-weighted measurements as a cross-cutting issue. The staff will bring back the issue of how to estimate the costs when the Boards discuss how to measure the transaction price (ie whether a probability-weighted method is appropriate in either case).

Most of those respondents suggested that the onerous test be conducted at a higher unit of account, generally the contract level, for the following reasons:

(a) Items are often not priced at a performance obligation level, rather at a contract level. Entities often price part of the contract at a loss in order to secure the contract and generate sales on other profitable goods or services within the contract (or within a portfolio of contracts).

(b) It is misleading to recognise a loss on part of the contract, either at inception (ie Day 1) or subsequently (ie Day 2), when the overall contract is profitable.

(c) The constraints on estimating variable consideration in the exposure draft mean that all performance obligations with variable consideration that cannot be reliably estimated will be identified as onerous.

(d) Costs may not be tracked at a performance obligation level which might make the test impractical.

(e) Existing requirements in IAS 11 *Construction Contracts,* ASC subtopic 605-35 *Construction-Type and Production-Type Contracts* and IAS 37 apply the onerous test at the contract level. (But note that existing practice for construction contracts often considers the whole contract, including satisfied *and* remaining performance obligations, rather than just the remaining performance obligations in the contract.)

12. Many respondents were particularly concerned about performance obligations being identified as onerous at contract inception if the contract as a whole is profitable. Respondents observed that this may often occur when the contract includes both high and low margin items and a contract discount is provided. This is because other parts of the model would require an entity to allocate the discount to the separate performance obligations in proportion to their standalone selling price[4].

[4] paragraph 50 of the Exposure Draft.

13. This is illustrated in the following simple example, in which allocating the discount of CU25 in proportion to the standalone selling prices results in the low margin Product B being identified as onerous, even though the contract as a whole is profitable.

	Standalone selling price	Costs	Allocation of the transaction price of **CU100**		***Day 1*** Onerous performance obligation (loss)	***Day 2*** Profits (losses) recognised on transfer
Product A	50	10	40		-	30
Product B	75	70	60		(10)	-
Total	125	80	100		**(10)**	**30**

14. Some respondents suggested that applying the onerous test to the contract rather than separate performance obligations would still create anomalous results and, therefore, suggested the test be conducted at a unit of account that is higher than the contract level, such as the customer relationship level or a portfolio of contracts level. The customer relationship level may be relevant in industries in which the initial contract with a customer is intentionally priced as loss-making (ie a ‘loss-leader’) in expectation of profits to be earned on subsequent contracts with the customer (eg the sale of a razor, with the expectation of subsequent sales of razor blades). In addition, the portfolio of contracts level may be relevant in industries in which a number of contracts with different customers will be satisfied at the same time. The total costs of these contracts (when combined) might be fixed or relatively certain, therefore the contracts might be priced interdependently to maximise profit for the portfolio as a whole, rather than profit per contract (eg tickets for an airline flight).

Staff analysis

Interaction with other parts of the model

15. The staff observes that many of the respondents' concerns would be addressed by changes to other parts of the revenue recognition model even if the Boards were to retain the performance obligation as the unit of account to which the onerous test is applied. This is explained in the table below. In addition, some concerns might be addressed if the Boards were to limit the contract costs to be used in applying the test compared to those proposed in the exposure draft, as discussed later in this paper. Clearly, the more the costs are limited, the less likely it is that a performance obligation would be identified as onerous.

<table>
<tr><th></th><th>Summary of respondents' concerns</th><th>How the concerns might be addressed</th></tr>
<tr><td>1</td><td>Entities manage their business, price their products and tracks their costs at the contract level. Applying the test to separate performance obligations will be difficult and is inconsistent with existing requirements.</td><td>Refine indicators for identifying separating performance obligations

The Boards' tentative decision in January to refine the guidance for separating performance obligations would result in an entity identifying fewer separate performance obligations than respondents interpreted from the exposure draft. In particular, many construction contracts would constitute a single separate performance obligation. Therefore, in such cases applying the test to either the performance obligation or the contract would yield the same result, would be more consistent with the existing requirements (IAS 11 and ASC 605-35) and would also address a number of respondents' concerns. For instance:

<blockquote>accounting for long-term contracts as one single performance obligation under the proposed ASU would appropriately result in the recording of a liability and expense only when a long-term contract is expected to be onerous, or unprofitable, in total, which we believe is appropriate and accurately reflects the economics of many long-term projects. [CL #260]</blockquote>
Refining the indicators for identifying separate performance obligations would also address the concern that some respondents do not track their costs at a granular level. This is because the separate performance obligations identified by the revised indicators would more closely align with business processes, for which the staff believe that cost information would be available.</td></tr>
</table>

	Summary of respondents' concerns	How the concerns might be addressed
2	Recognising a loss for one performance obligation when the rest of the contract is profitable is misleading.	*Refining criteria for allocation and discounts* Many respondents observed that allocating the transaction price and discounts on a relative stand-alone selling price basis would result in an inappropriate allocation of discounts as illustrated in paragraph 13. Refining the principles for allocation should generate more meaningful inputs to the onerous test and, therefore, result in fewer obligations being assessed as onerous at the inception of the contract when the contract as a whole is profitable. (Allocation of the transaction price will be discussed in March.)
3	The consideration to be received for the remaining performance obligations may be variable. If the transaction price cannot be reasonably estimated, the remaining performance obligations will be assessed as onerous.	*Refining constraints for estimating variable consideration* The exposure draft constrains estimates of the transaction price for variable consideration that should be allocated to both satisfied and remaining performance obligations. By refining the criteria to constrain estimates only for satisfied performance obligations, an entity would be able to estimate consideration for the remaining performance obligations for purposes of the onerous test. This approach would therefore decrease the likelihood that the remaining performance obligations will be assessed as onerous.

Should the onerous test apply to the contract?

16. Although changes to other parts of the model should address many of the respondents' concerns (particularly with respect to recognising a loss at contract inception for an otherwise profitable contract), the following concerns would remain with applying the onerous test at the performance obligation level.

An onerous liability could be recognised for a performance obligation at contract inception, even though the contract as a whole is profitable

17. In most cases, an entity enters into a contract with the expectation of making a profit on the contract as a whole. For accounting purposes (and also maybe for management purposes), the entity allocates revenue to the separate performance obligations in the contract. However, to some extent those allocations are somewhat arbitrary given that the entity negotiated an overall price for the contract.

18. As noted, in March the Boards will redeliberate how an entity should allocate the transaction price to the performance obligations in a contract and, as a result, they may amend how discounts are allocated in the contract. However, it is still possible that, as a result of the allocation process and any constraints that the Boards build into that process, a performance obligation would be identified as onerous at contract inception, even though the contract as a whole is profitable. Many argue that recognising an onerous liability in such situations would not faithfully depict the entity's financial position.

An onerous liability could be recognised for a performance obligation after contract inception, even though the remainder of the contract is profitable

19. After contract inception, adverse changes in circumstances could result in a performance obligation being identified as onerous, even though the loss on that performance obligation is covered by the margin on other remaining profitable

performance obligations. In other words, viewed collectively, the remaining performance obligations in the contract remain profitable.

20. Although the Boards proposed that recognising an onerous liability in such situations would result in useful information, many respondents disagree. They do not think it would faithfully depict the entity's financial position:

> The proposed approach in the ED could have the effect of recognising losses on part of the project even when it can be reliably estimated that the contract as a whole will result in a profit. We do not think that this is a fair representation of the economic effect of the contract and believe that it can result in the wrong message being conveyed to users. [CL #278]

21. In addition, the comments about allocation in paragraph 17 apply.

Identification of onerous performance obligations might depend on the timing of the transfer of goods or services

22. The Boards have decided that distinct goods and services should not be accounted for as separate performance obligations if they are transferred to the customer at the same time. If the onerous test were to be conducted at the performance obligation level, the identification of onerous performance obligations might depend on whether goods or services are transferred at the same time. For instance, assume two entities (A and B) contract to provide the same two distinct services, one of which is loss-making but the contract as a whole is profitable. Entity A provides the services consecutively, Entity B concurrently. Entity A would recognise an onerous liability at contract inception for the loss-making service (because each service is a separate performance obligations), Entity B would not (because it has only one separate performance obligation consisting of the two services). To avoid that outcome, the Boards would need to specify that an entity determines whether each distinct good or service is onerous, which would be complex and would create another unit of account.

Capitalised acquisition costs would need to be attributed to separate performance obligations

23. At the meeting on 2 February, the Boards decided tentatively to require an entity to capitalise acquisition costs that are incremental to obtaining a contract. To ensure that the asset recognised from acquisition costs is not overstated, it needs to be included in the onerous test (ie an entity needs to compare (a) the transaction price with (b) the cost of the fulfilling performance obligation and the unamortised acquisition costs). Conducting the onerous test at the performance obligation level would require the acquisition costs to be attributed to separate performance obligations, increasing the complexity of the test.

Recommendation

24. The staff acknowledges that an advantage of applying the onerous test at the level of the separate performance obligation is that the test would largely be independent of how the entity bundles its goods or services into contracts. However, the staff thinks that this advantage is outweighed by the disadvantages noted above in paragraphs 17-23. Accordingly, the staff recommends that an entity conduct the onerous test at at least the level of the contract rather than separate performance obligation.

25. As noted above, in suggesting that the Boards use the contract level, some respondents meant the whole contract (including the satisfied performance obligations). However, to be consistent with the model, the staff thinks that the contract level should be described as the *remaining* performance obligations in the contract. Although this articulation would be different from IAS 11 and ASC 605-35[5], the staff understands it would be consistent with how current guidance is interpreted and applied in some cases.

26. The next section considers whether in some cases the test needs to be applied at a higher level than the (remaining performance obligations in the) contract.

[5] For instance, paragraph 36 of IAS 11 states that when '*total* contract costs will exceed *total* contract revenue, the expected loss shall be recognised' (emphasis added).

Should the onerous test apply to a higher unit of account than the contract?

27. If the Boards were to apply the test to the remaining performance obligations in a contract, they would have addressed many of the concerns of respondents about recognising onerous liabilities for profitable contracts. However, they would not have addressed the concerns of respondents who stated that it is inappropriate for an entity to recognise an onerous liability on entering into a *contract* that is priced at a loss in the expectation of obtaining future profitable contracts (often referred to as a 'loss leader').

28. Respondents think that it is inappropriate to recognise an onerous liability in such cases because the liability implies the contract was a 'bad deal', whereas in fact the entity has not only acquired a contract but, typically, a highly valuable customer relationship asset that it expects to yield a stream of future profitable contracts. (Of course, that customer relationship asset is typically not recognised and, hence, when the entity satisfies the performance obligations, it will recognise a loss.)

29. Consequently, the staff considered whether the onerous test should be applied to a higher unit of account, such as to the customer relationship or to a portfolio of contracts. However, the staff thinks it would be difficult to draw the boundary of the higher unit of account. Furthermore, creating a unit of account that is relevant only for the purposes of the onerous test might create unnecessary complexity.

30. The staff has therefore explored two other ways of addressing this issue.

    (a) Option A: apply the test only after contract inception, or

    (b) Option B: exclude loss leaders from the onerous test.

Option A: Apply the test only after contract inception, so that it identifies only adverse changes in circumstances after contract inception

31. The basis for the approach is that it is rare for an entity to enter into a loss-making contract without obtaining other economic benefits (such as a customer relationship). So in many cases, recognising an onerous liability at contract

inception would inappropriately depict the contract as economically onerous. A drawback of this approach is that an entity could fail to recognise a loss on entering into a 'bad' contract (ie a contract that is economically onerous and is not loss-making simply because of the accounting).

Option B: Exclude loss-leaders from the onerous test at contract inception

32. The basis for this approach is that such contracts are not economically loss-making—the loss arises because the other assets the entity obtains are not recognised. A drawback of this approach is that the Boards would need to define a loss-leader.

33. As noted above, both of these options have drawbacks. However, the staff thinks Option B minimises the risk of failing to recognise an onerous liability for a contract that is economically onerous (ie a 'bad deal').

34. Therefore, the staff recommends creating an exception to the requirement to recognise a liability for an onerous contract. That exception should specify that an entity should not recognise a liability for an onerous contract if, in specified circumstances, the entity entered into that contract in order to obtain profitable future contracts.

35. The likelihood of obtaining future contracts to recover the loss on an initial contract could vary from virtually certain to remote. For instance, the loss on a contract for a product that requires the customer to purchase additional supplies or services to continue to use the initially acquired product might be more likely to be recoverable directly than, say, the loss on a contract that was entered into to establish a new market for the entity or to enhance the entity's reputation by entering into a contract to achieve socially responsible objectives.

36. Accordingly, if the Boards agree with the staff recommendation, the staff suggests that the exception be limited to situations in which the entity:

    (a) expects to recover the loss through subsequent contracts that are functionally linked with the loss-making contract; and

(b) has sufficient relevant experience to determine that it will obtain those subsequent contracts.

Staff recommendations

Questions 1 and 2
Do the Boards agree that: 1) An entity should conduct the onerous test at the level of the remaining performance obligations in the contract. 2) However, an entity should not recognise an onerous liability on entering into a contract if the entity: (a) expects to recover the loss on that contract through subsequent contracts that are functionally linked with the loss-making contract; and (b) has sufficient relevant experience to determine that it will obtain those subsequent contracts.

Costs to be included in the onerous test and the onerous liability

Background

37. For the purposes of (a) determining if a performance obligation is onerous and (b) the amount of the onerous liability, the exposure draft proposed that entities consider 'the costs that relate directly to satisfying [the] performance obligation'. The 'costs that relate directly' to satisfying the performance obligation were defined as follows:

> (a) direct labour (for example, salaries and wages of employees who provide services direct to the customer);
>
> (b) direct materials (for example, supplies used in providing services to the customer);
>
> (c) allocations of costs that relate directly to the contract or contract activities (for example, costs of contract management and depreciation of tools and equipment used in fulfilling the contract);
>
> (d) costs that are explicitly chargeable to the customer under the contract; and

(e) other costs that were incurred only because the entity entered into the contract (for example, subcontractor costs).

38. The exposure draft proposed using the same definition of costs in connection with capitalising contract fulfilment costs.

Feedback from respondents

39. Some respondents explained that they agreed with the approach in the exposure draft of using the same definition of costs for (a) applying the onerous test and (b) accounting for contract fulfilment costs. Many respondents also agreed with the costs defined in paragraph 58 of the exposure draft. Some of those respondents highlighted the need to include some allocation of costs, because if not, losses simply would be deferred.

40. However, some respondents thought that the onerous test should be performed by reference to only the incremental costs to fulfilling the obligation. That is because in some cases it is economically rational for entities to price their contracts to cover only incremental costs and also, in such cases, entities view contracts that cover incremental costs as contributing to margin.

> We also believe that only directly and incremental costs should be used for purposes of applying the onerous test. We believe this change would provide more useful information for contracts that are accretive to earnings when they cover variable costs (but would not be sufficient to cover allocated fixed costs). [CL #503]

41. These respondents also explained that considering more than the incremental costs in the onerous test would frequently generate onerous performance obligations in industries with a high proportion of fixed costs.

42. Some respondents suggested that the Boards use the principle from IAS 37 of the ‘unavoidable costs of meeting the obligations’.

43. Some respondents were also concerned about the application of the requirements to individual contracts that are not designed to recover all the directly attributable costs of fulfilling the performance obligation (or contract), as in the case of the sale of an airline ticket or a ticket in the entertainment industry.

Staff analysis

44. The feedback highlights two main issues.

1) Allocation of costs

45. Some respondents are concerned that an entity would be required to recognise an onerous liability for all the direct costs of a flight, entertainment event, or similar item, when the first ticket is sold. Clearly, the Boards did not intend all of the direct costs of a flight or an entertainment event to be attributed to a single ticket. They envisaged an entity including the direct costs associated with each ticket and an *allocation* of the direct costs relating to the flight or entertainment event. This can be clarified in drafting.

2) Definition of costs is too broad

46. A few respondents are concerned about the extent, or type, of costs used in the onerous test and in measuring the onerous liability. They think the costs should be limited to the costs that are incremental to performance of the contract—ie they think costs that would have been incurred even if the entity did not have to perform under the contract should be excluded. Therefore, in contrast to the exposure draft, using incremental costs would exclude many of the allocations of costs that relate directly to contract activities. Using incremental costs would also exclude some direct costs, such as the costs of personnel who would be retained regardless of whether the entity has the contract.

47. The staff thinks that the basis for this concern is a fundamental disagreement with the onerous test. These respondents think that the onerous liability is the recognition of an accrual for future costs rather than a *(re)measurement* of the performance obligations. Hence, they view the proposals in the exposure draft as accelerating the recognition of expenses that they think should be recognised in profit or loss as incurred. They therefore think that the onerous liability should

exclude costs that the entity would have incurred regardless of whether it had the contract.

48. The staff acknowledges that the onerous test appears to be a liability recognition and measurement issue, because it results in the recognition of a separate liability that has no effect on the revenue recognition. Nonetheless, conceptually, the onerous test is a (re)measurement issue, because there has been no new obligating event. It is, in effect, an impairment test for the performance obligations. Given that, it seems appropriate to include all of the direct costs of fulfilling the performance obligations (including allocations of costs that relate to the entity's contract activities in general) in the measurement of the onerous liability, as proposed in the exposure draft.

49. Furthermore, the staff notes concerns about changing the approach in the exposure draft:

    (a) Limiting costs to only incremental costs would be a significant change to the existing requirements in IAS 11 and ASC 605-35 for construction contracts, which are similar to those in the exposure draft. Onerous liabilities are most common in construction contracts, simply because of the risks in, and duration of, those contracts. The staff is not aware that users have concerns with the current requirements.

    (b) Because the costs would be more narrowly defined, fewer contracts would be determined to be onerous. That could delay reporting adverse changes in circumstances to users.

    (c) Many respondents like that the exposure draft proposed the same definition of costs for (a) the recognition of assets from fulfilment costs and (b) the onerous test. It would be more complex for, say, a construction entity to use a different definition of costs for the onerous test and for accounting for its fulfilment contract costs.

50. Therefore, the staff recommends that the Boards affirm their proposals in the exposure draft. Accordingly, for the onerous test and measurement of the onerous

liability, costs should be the costs that relate directly to a contract. The Boards will need to reconfirm this decision after they have refined the definition of those costs when they consider contract costs.

51. Finally, the staff thinks that that the onerous test should reflect the notion from IAS 37 of the 'least cost of exiting from the contract'. In other words, the costs should be the lower of (a) the costs that relate directly to satisfying the performance obligation and (b) any amounts the entity would have to pay to cancel the contract (eg the amount it would have to refund the customer, including any penalties). This would reflect that all other things being equal, an entity rationally would cancel a contract rather than fulfil it if that were the less expensive option.

Staff recommendation

Question 3

Do the Boards agree that for the onerous test and measurement of the onerous liability, costs are the lower of:

(a) the costs that relate directly to the contract (as proposed in the exposure draft), and

(b) any amounts the entity would have to pay to cancel the contract (eg the amount it would have to refund the customer, including any penalties)?