
Project **Revenue Recognition**

Topic **Onerous contracts**

Purpose of the discussion

1. Agenda Paper 4G/Memo 137G for the joint February 16-18 meeting outlined various issues in applying the test for onerous performance obligations. The boards discussed the first issue in that paper and tentatively decided that the unit of the account for the onerous test should be the remaining performance obligations in a contract.
2. There were two other issues in that paper that the boards did not have time to discuss:
 - (a) whether the boards should address concerns related to contracts intentionally priced as loss-making in expectation of profits to be earned on subsequent contracts with the customer, ie ‘loss-leader’ contracts (paragraphs 14 and 27-36); and
 - (b) the costs to be included in the onerous test and in measuring an onerous liability (paragraphs 37-51).
3. The purpose of the March 1-2 meeting is to discuss those two issues.
4. Agenda Paper 4G/Memo 137G has been reposted without amendment for this meeting as Agenda Paper 4A/Memo 138A. This paper provides a summary of

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those recommendations and reframes the questions for the boards to facilitate the discussion.

Introducing an exception for ‘loss-leader’ contracts

5. The analysis of the issue of loss-leader contracts is presented in paragraphs 14 and 27-36 of Agenda Paper 4A/Memo 138A. To address this issue, the staff present two options for the boards:
 - (a) **Option A:** Apply the onerous test only after contract inception so that it identifies only adverse changes in circumstances after contract inception (paragraph 31). This exception would be a practical way of addressing the issue of loss-leader contracts. However the exception would apply to all contracts and therefore an entity would not recognize an onerous contract liability for any contract that is loss-making at inception (and that does not experience adverse changes in circumstances).
 - (b) **Option B:** Exclude only loss-leader contracts from the onerous test at contract inception (paragraphs 32-36). This exception would apply only to loss-leader contracts, which the boards would need to define.
6. The staff’s objective with these two options is only to allow an entity to avoid recognising a liability for a loss-leader contract *at contract inception*. The entity would recognise any loss that arises on the contract at the time of transfer to the customer.

Staff recommendation

7. The staff recommend that the concerns related to loss-leader contracts be addressed by excluding specified loss-leader contracts from the onerous test at contract inception (Option B).
8. If the boards agree, then they need to decide which loss-leader contract should be exempted from the onerous test. In paragraph 36 of Agenda Paper 4A/Memo

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138A, the staff recommend that the exception be limited to situations in which the entity expects to recover the initial loss through subsequent contracts that are ‘functionally linked’ with the loss-making contract. By this, the staff envisaged that that the loss would need to be recovered through subsequent contracts that are necessary for, or to maintain, the function (or utility) of the initial good or service.

9. The staff requests the boards provide direction as to whether the exception has been presented at the correct level. Then the staff will determine how best to draft the exception. For instance, you may want to make it more restrictive, say to capture only those situations in which the customer *must* enter into subsequent contracts with the entity (rather than being able to purchase the required follow-up goods or services from other entities).

Questions 1, 2 and 3

Do the boards agree with the staff recommendation to introduce an exception in the onerous test to address concerns related to loss-leader contracts?

Do the boards agree with the staff recommendation that the exception should exclude specified loss-leaders from the onerous test at contract inception?

Do the boards agree in principle with how the loss-leaders to be exempted from the onerous test have been defined? If not, which loss-leaders should be exempted?

Costs to be included

10. The analysis of the issue of the costs to be included in the onerous test and in measuring the onerous liability is presented in paragraphs 37-51 of Agenda Paper 4A/Memo 137A. The staff considered whether to narrow the costs to be included in the onerous test to costs that are incremental to performance of the contract, or

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to affirm the proposal in the exposure draft to include ‘costs that relate directly to satisfying [the] performance obligation (as described in paragraph 58)’.¹

Staff recommendation

11. The staff recommends that for the onerous test and the measurement of the onerous liability the costs are the lower of:
- (a) the costs that relate directly to the contract (as proposed in paragraph 58 of 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).

Question 4

Do the boards agree with the staff recommendation?

¹ Paragraph 55 of the Exposure Draft *Revenue from Contracts with Customers*.