	IASB/FASB Meeting **Week commencing May 16, 2011**	IASB Agenda reference	**4C**
Staff Paper	***FASB Education Session May 11, 2011***	FASB Agenda reference	**143C**

Project	**Revenue Recognition**
Topic	**Onerous contracts**

Purpose

1. The purpose of this paper is to request the Boards to reconsider the application of the onerous test.

Summary of staff recommendations

2. The staff recommends the following:

   (a) modifying the onerous test such that when more than one contract is satisfied at the same time by a single act, an entity would recognise an onerous liability only when those contracts are (collectively) expected to be onerous;

   (b) the onerous test should be applied only to performance obligations that an entity satisfies over time; and

   (c) (FASB only) when a not-for-profit entity enters into a contract with a customer for a social benefit or charitable purpose, those contracts should be exempted from the onerous test.

Background

3. In February and March 2011 the Boards tentatively decided that:

   (a) The onerous test should be applied to the remaining performance obligations in a contract.

   (b) The costs to be included in the onerous test are those that relate directly to fulfilling the contract (ie the fulfillment costs).

   (c) If an entity has committed to cancelling a contract, and it has the contractual right to do so, the costs would reflect the amount the entity would have to pay to cancel the contract.

   (d) The onerous test should not include an exception for loss-leaders.

4. Since the Boards' tentative decisions, the staff have received feedback (including a comment letter from the US airline industry, CL #973) expressing concerns about the consequences of applying the onerous test in some circumstances. It is not clear whether the Boards intended all of those consequences. Therefore, the staff have considered examples that illustrate when the staff thinks applying the onerous test does not generate meaningful results. This is because, for example, the contracts may not be economically burdensome when analysed at a level higher than the contract or when other factors are considered. Those examples are included in the analysis below.

Staff analysis

More than one contract fulfilled at the same time

5. Some examples of when the onerous test does not appear to generate meaningful results is when an entity enters into more than one contract and the contracts are fulfilled at the same time by a single act. Examples of these contracts are as follows:

   (i) Airline tickets (ie seats on a flight)

   (ii) Entertainment (eg tickets for a show, play, concert, etc.)

(iii) Shipping (eg some cargo containers priced at lower rates to fill ship)

(iv) Passage on a cruise ship

(v) Magazine subscriptions (and related advertising revenue)

6. As it is currently proposed, an entity would be required to apply the onerous test to each individual contract (ie a ticket for a flight). This approach would not generate meaningful results because it does not reflect the fact that the contracts are priced, and their profitability is assessed, based on a unit of account higher than the individual contracts (ie a flight). Additionally, testing each contract separately when they will be fulfilled at the same time, seems inconsistent with the criterion that allows an entity to account for performance obligations (arising from a single contract) together when the pattern of transfer is the same.

Staff recommendation

7. Therefore, the staff recommend modifying the onerous test such that when more than one contract is satisfied at the same time by a single act, an entity would recognise an onerous liability only when those contracts are (collectively) expected to be onerous. Given that this alternative requires an entity to assess whether current and future contracts are collectively *expected* to be onerous, an entity must have sufficient relevant experience to make the assessment.

8. This modification to the onerous test for the cases specified would change the unit of account from the contract level to a level that is higher than the contract. However the modification would also simplify the application of the onerous test for those cases and provide more meaningful information, given that the contracts are priced collectively and fulfilled at the same time.

Question 1 for the Boards
Do the Boards agree that the onerous test should be modified such that when more than one contract is satisfied at the same time by a single act, an entity would recognise an onerous liability only when those contracts are (collectively) expected to be onerous? If not, why not?

Other examples

9. The following table includes a list of the other examples that illustrate different consequences of applying the onerous test. The table also provides alternatives for modifying the onerous test, if the Boards determine that those consequences were not intended. The alternatives are explained further below.

			ALTERNATIVES (an 'x' indicates that the alternative would not require an entity to recognise an onerous loss at contract inception for the particular example)		
	Examples	***Reasons why applying the onerous test will not generate meaningful results***	**Limit the onerous test to performance obligations satisfied over time**	**Compare the economic benefits expected to be received from the contract to the costs to fulfill**	**Define costs to reflect the notion of least cost of exiting the contract**
(a)	Airlines that price on network basis (ie the last flight of day from Toronto to NYC may be unprofitable, but the plane is needed in NYC for first flight in morning, which is profitable)	Applying the test using only the transaction price (for the flight) does not take into account other benefits (ie profits on future contracts).	X	X	X
(b)	Specialized product sold at a loss in anticipation of profitable subsequent contracts for servicing and parts for the product	Applying the test using only the transaction price (for the product) does not take into account other benefits (ie profits on future service contracts).	X	X	
(c)	Printer sold at a loss, in anticipation of receiving profits on future sales of ink cartridges	Applying the test using only the transaction price (for the printer) does not take into account other benefits (ie profits on the sales of ink).	X	X	

			ALTERNATIVES (an 'x' indicates that the alternative would not require an entity to recognise an onerous loss at contract inception for the particular example)		
	Examples	***Reasons why applying the onerous test will not generate meaningful results***	**Limit the onerous test to performance obligations satisfied over time**	**Compare the economic benefits expected to be received from the contract to the costs to fulfill**	**Define costs to reflect the notion of least cost of exiting the contract**
(d)	Manufactured units; first unit is manufactured at a loss. However technical know-how is gained and will be applied to generate greater profits on manufacturing and delivery of future units	Applying the test using only the transaction price (for the initial contract) does not take into account other benefits (ie profits on future contracts as a result of technical know-how gained).	X	X	

Description of the other alternatives

10. In the examples in the table above, the staff thinks it would not be appropriate for an entity to recognize an onerous loss *at contract inception.* However, any loss still might be recognised when the entity transfers the promised good or service. As indicated by the table, the consequences of applying the onerous test to the examples listed can be addressed by the three alternatives:

    (a) limiting the onerous test to performance obligations satisfied over time,

    (b) comparing the economic benefits expected to be received from a contract to the costs to fulfill it, or

    (c) define the costs to reflect the notion of least cost of exiting the contract.

(a) Limit the onerous test to performance obligations satisfied over time

11. One alternative for addressing the concerns resulting from the examples listed in the table is to limit the scope of the onerous test to performance obligations that are satisfied over time.

12. This alternative is closest to the existing requirements that would be superseded by the final revenue standard. That is, the onerous tests in existing 'revenue' standards are found in IAS 11 *Construction Contracts* and Topic 605 *Construction-Type and Production-Type Contracts.* Additionally, this alternative leverages the Boards' previous tentative decision to provide criteria to determine when a performance obligation is satisfied over time. Hence, this alternative would not require the Boards to develop an additional definition.

13. In this alternative, performance obligations that are not satisfied over time would be subject to impairment testing in other standards. For example, existing standards on inventory already provide guidance on how an entity should test for impairment inventory that is subject to a sales contract. That guidance also requires that an entity recognise a loss that is expected to exceed the carrying amount of the inventory. (The staff observes that the impairment

of inventory or expected loss on the contract may not always be recognised at contract inception.)

14. For a performance obligation satisfied over time, an entity already would be required to measure progress toward complete satisfaction of that performance obligation. That requires an entity to evaluate the outcome of the performance obligation. Hence, the staff thinks the final standard could include the onerous test in the discussion of measuring progress.

(b) Compare the economic benefits expected to be received from the contract to the costs to fulfill

15. In some cases, an entity may enter into a contract because the economic benefits expected to be received from the contract are greater than the costs to fulfil it. In these cases, this alternative would require an entity to complete the onerous test by comparing the *economic benefits to be received from the contract* to the costs to fulfil the contract.

16. In this alternative, when the economic benefits (including, but not limited to the transaction price) exceed the costs, the contract would not be identified as onerous and no loss would be recognised when the contract is entered into. However, a loss would be recognised when the costs exceed the economic benefits.

17. This alternative recognises that the benefits received from a contract may be greater than the transaction price and is based on the view that it would be more meaningful to consider the other benefits when assessing whether the contract is onerous. Additionally, this alternative considers the fact that in some cases, a customer relationship intangible asset may exist on Day 1 (because the item sold may yield future profitable contracts with the customer), although it is not recognised as an asset.

18. The measurement of the 'economic benefits to be received under a contract' may not always be clear, however it is a concept that currently exists in the definition of an asset and the onerous test in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. To provide more clarity, the Boards may wish to provide some additional guidance in the revenue standard.

19. In this alternative the onerous test would be applied to all contracts (not just those that are fulfilled over time). Hence, the final standard would carry forward the guidance in the ED that requires an entity to first test any inventory (or other assets) for impairment before recognising an onerous loss for the contract.

(c) Define the costs to reflect the notion of least cost of exiting the contract

20. Another alternative for modifying the onerous test is to define the costs to be included in the onerous test as the least cost of exiting the contract (irrespective of whether an entity has committed to cancelling the contract). Those costs would be the lower of:

    (i) The costs that relate directly to fulfilling the contract, and

    (ii) Any amounts an entity would have to pay to cancel the contract.

21. This alternative reflects the fact that in some cases an entity would rationally cancel a contract, rather than fulfil it, if that were the less expensive option. This notion also currently exists in the onerous test in IAS 37.

Staff recommendation

22. The staff thinks that the alternatives of:

    (a) limiting the onerous test to performance obligations satisfied over time, and

    (b) comparing the economic benefits expected to be received from the contract to the costs to fulfil it,

    would both improve the application of the onerous test and result in more useful information about the types of contracts summarized in the table following paragraph 9. Nevertheless, the staff recommends that the onerous test should be limited to performance obligations satisfied over time because it would minimize the risk of unintended consequences with the onerous test, given that it is closest to the existing requirements in IAS 11 and Topic 605.

Additionally, limiting the test to performance obligations satisfied over time would be more straightforward to apply in practice, because it avoids the potential for inconsistencies in how entities interpret the notion of 'economic benefits' and it avoids the inclusion of estimates related to future contracts.

Question 2 for the Boards
Do the Boards agree that the onerous test should be modified by limiting its scope to performance obligations that an entity satisfies over time? If not, do the Boards prefer another alternative to address the examples in the table?

Not-for-profit entity contracts providing social benefits: exemption from the onerous test (FASB only)

23. Some not-for-profit entities enter into contracts with customers that are loss-making because they provide a social benefit or charitable purpose (eg some contracts in health care or education). Applying the onerous test to these contracts requires an entity to identify them as onerous and recognise a loss when the contract is entered into, instead of when the benefit is provided.

24. In the staff's view, this result does not provide meaningful information and seems inconsistent with the objective of financial reporting in FASB Statement of Financial Reporting Concepts No. 4 *Objectives of Financial Reporting by Nonbusiness Organizations*. For example, paragraph 51 of Concepts Statement 4 indicates that 'information about an organization's service efforts and accomplishments is useful to resource providers and others in assessing the performance of a [not-for-profit] entity and in making resource allocation decisions'. Concepts Statement 4 also acknowledges that the ability to measure service accomplishments is generally undeveloped. However, Concepts Statement 4 also seems to indicate that costs for services should be recognised when the service is provided (instead of when the contract is entered into). Paragraph 52 notes that 'financial reporting should provide information about service efforts [and that] techniques for measuring the costs

of significant programs or services are well developed and this information normally should be included in financial statements'.

25. Given that the onerous test could result in recognition of a cost before the entity provides the contracted charitable service, the staff thinks that would conflict with the stated objectives of financial reporting and information needs of donors, grantors, and other resource providers of not-for-profit entities. Therefore, the staff recommends that when a not-for-profit entity enters into a contract with a customer for a social benefit or charitable purpose, those contracts should be exempted from applying the onerous test.

Question 3 for the FASB
Does the FASB agree that when a not-for-profit entity enters into a contract with a customer for a social benefit or charitable purpose, those contracts are exempted from applying the onerous test? If not, why not?