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STAFF PAPER

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Project	**Revenue recognition**
Paper topic	Identifying onerous losses

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Purpose of the paper

1. This paper considers:

   (a) whether the revenue standard should include requirements to identify and measure onerous losses on contracts with customers; and

   (b) if so, how those requirements can be improved to reduce complexity and ensure that onerous losses are recognized only in circumstances when it would provide useful information for users.

2. This paper does not address disclosures related to the onerous test. These will be addressed as part of the broader discussions on disclosures.

Summary of recommendations

3. The staff recommend the Boards retain a requirement to identify and measure onerous losses on contracts with customers (ie an onerous test) in the revenue proposals.

4. To improve those requirements and provide useful information, the staff also recommend the following modifications to the onerous test:

   (a) change the scope of the test so that it applies to *all* performance obligations (ie performance obligations satisfied at a point in time and performance obligations satisfied over time, including those satisfied over a period of time less than one year),

   (b) change the unit of account to the contract level (that is, the aggregate of the *remaining* performance obligations in the contract),

   (c) changethe costs considered in identifying onerous contracts and measuring onerous losses to the lower of the following amounts:

      (i) the costs that are incremental to satisfying the aggregate of the remaining performance obligations in the contract, and

      (ii) the amount the entity would have to pay to exit the contract, if the entity was permitted to do so, other than by transferring the promised goods or services

   (d) (FASB only) clarify that the assessment of whether a contract can be excluded from the onerous test for not-for-profit entities should be completed at the individual contract level (not at an entity level).

Structure of the paper

5. This paper is organized into the following sections:

   (a) Background of the proposals in the 2011 Exposure Draft (paragraphs 6-8)

   (b) Feedback on the onerous test in the 2011 Exposure Draft (paragraphs 9-14)

   (c) Should the revenue standard include an onerous test? (paragraphs 15-18)

   (d) Improving the onerous test in the revenue proposals (paragraphs 19-62)

      (i) Modifying the scope of the onerous test (paragraphs 20-22)

(ii) Changing the unit of account (paragraphs 23-38)

(iii) Modifying the measurement of the test (paragraphs 399-62)

(e) (FASB only) Applying the onerous test to not-for-profit entities (paragraphs 63-64)

Background of the proposals in the 2011 Exposure Draft

6. The onerous test proposed in the 2011 Exposure Draft would apply only to performance obligations satisfied over time and over a period of time greater than one year (paragraph 86 of the 2011 Exposure Draft). For those performance obligations, an entity should recognize an onerous liability and a corresponding expense if the lowest cost of settling the performance obligation exceeds the transaction price allocated to that performance obligation (paragraph 87 of the 2011 Exposure Draft). The lowest cost of settling the performance obligation is the lower of the following amounts:

   (a) the costs that relate directly to satisfying that performance obligation (those costs are described in paragraph 92 of the 2011 Exposure Draft); and,

   (b) the amount the entity would have to pay to exit the performance obligation if the entity is permitted to do so.

7. In reaching the decisions in the 2011 Exposure Draft on the onerous test, the Boards considered a number of alternatives for improving the onerous test and addressing respondents' comments. These included:

   (a) applying the test at the contract level;

   (b) in some circumstances, applying the test to a group of contracts that would be satisfied by a single act;

   (c) excluding from the test contracts that are priced at a loss in the expectation of obtaining future profitable contracts (ie 'loss-leaders');

   (d) applying the test only after contract inception (ie 'Day 2'); and

(e) incorporating the notion of economic benefits.

8. However, many of those alternatives would not have identified some loss-making contracts as onerous or, conversely, would have identified contracts as onerous when many would argue that the contracts were not truly economically burdensome to an entity. This may be because many of the alternatives were considered individually rather than in combination. For example, initially, the Boards tentatively decided to modify the unit of account for the onerous test such that it would be applied at the contract level (that is, to the aggregate of the remaining performance obligations in a contract). However, without further adjustments to other aspects of the onerous test, applying the test at the contract level would have adverse consequences for industries who price their goods or services to be profitable at a level above the contract (eg airlines, theatre tickets, financial services, and media and entertainment).

Feedback on the onerous test in the 2011 Exposure Draft

9. Question 4 of the 2011 Exposure Draft asked respondents whether they agree with the scope of the onerous test. A very small number of respondents, including both users and preparers, agreed with the onerous test as proposed.

10. However, most respondents (primarily preparers and standard-setters) disagreed with the complexity caused by limiting the scope of the onerous test in the revenue proposals and relying on impairment tests in the inventory standards for performance obligations not included in the scope of that onerous test. Respondents also disagreed with other aspects of the test, such as the unit of account and measurement. Those respondents provided the following suggestions for modifying the onerous test:

    (a) apply the test to all performance obligations, including those satisfied at a point in time and those satisfied over a period of time less than one year;

    (b) apply the test at the level of the contract (rather than the performance obligation); and

(c) modify the measurement of the test as follows:

   (i) consider other economic benefits received from the contract instead of only the transaction price, (ie bringing the test closer to the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*), and/or

   (ii) limit the costs to be included in the test to be only the incremental costs directly related to satisfying the performance obligations in the contract.

11. Users had mixed views on the onerous test in general, as well as specific aspects of the test. Some users thought the proposals would capture performance obligations where they thought it was critical that an onerous loss should be recognized before performance has occurred (that is, long-term performance obligations that are satisfied over time). However, others thought that the limited scope created confusing differences that might make user analysis more difficult because similar performance obligations would be accounted for differently. This is because, for example, a performance obligation satisfied over 11 months would be excluded from the onerous test, whereas a performance obligation satisfied over 13 months would be included.

12. Users also thought that applying the test to individual performance obligations may create results that are not useful because management often prices and assesses profitability at the contract level or, in some industries, above the contract. In their view, it is inappropriate to recognize a liability for part of a contract if overall the contract is expected to be profitable. However, other users agreed with the Boards' decision that the same unit of account should be used for recognizing revenue and for recognizing an onerous loss.

13. In addition to those specific comments, some users (primarily users of financial statements that are prepared in accordance with IFRSs) suggested that existing guidance on onerous contracts was acceptable to them and thus, in their view, it was unnecessary to introduce a different test that would apply only to contracts with customers within the scope of the revenue standard.

14. Other respondents (preparers and standard-setters) also disagreed with the inclusion of the test in a revenue standard and suggested that the Boards instead rely on existing standards or begin a separate project on liabilities/provisions.

Should the revenue standard include an onerous test?

15. Many respondents suggested removing the onerous test from the revenue proposals because, in their view, the requirements for recognition of onerous losses should be included in other standards:

    (a) Respondents who apply or are knowledgeable about IFRSs explained that the onerous test in IAS 37 and the guidance in IAS 2 *Inventories* already provides sufficient guidance for determining when to recognize losses arising from contracts with customers.

    (b) Respondents who apply or are knowledgeable about US GAAP suggested that if a change is necessary to existing guidance on recognition of losses from contracts, that change could instead be handled in a separate project that addresses liabilities in Topic 450, *Contingencies*.

16. In light of this feedback and difficulties with applying the onerous test, the staff considered whether it was appropriate to remove the test from the revenue standard and instead rely on other standards. In IFRSs, this would result in entities referring to IAS 37 for guidance on onerous losses and in US GAAP, entities would refer to Topic 450.

17. However, some respondents have raised concerns that Topic 450 might not adequately capture losses on all revenue contracts (because it is interpreted and applied inconsistently) and, therefore, removing the onerous test from the revenue proposals would also require the FASB to retain other industry-specific guidance on loss recognition for onerous contracts (eg loss recognition guidance for contracts in the construction industry). (That industry-specific guidance would need to be retained because it is currently proposed to be replaced with the final revenue standard.) Retaining that guidance will however add complexity, because

it would require the FASB to specify to which contracts that loss-recognition guidance would apply.

Staff recommendation

18. The staff recommend that the revenue standard should include an onerous test for the following reasons:

   (a) The onerous test is an important part of measuring the contract with a customer and provides useful information for users by requiring the recognition of losses when those losses actually occur (ie in advance of performance).

   (b) Relying on existing standards in US GAAP would maintain the existing complexity related to loss recognition that many would like to simplify with the revenue proposals. In addition, some do not think existing guidance in US GAAP sufficiently captures executory contracts or long-term service contracts (other than construction and production contracts). Both concerns could be addressed with a separate project on provisions; however, challenges in defining the scope of that project and the time involved in completing the necessary due process steps may mean that it is unlikely that such a project would be completed before the revenue proposals are implemented.

   (c) Relying on existing guidance may raise requests for additional guidance on the application and interpretation of those standards, to ensure that losses on contracts with customers are adequately identified. Given that additional guidance may affect contracts outside of the scope of the revenue proposals, it would need to be considered as part of a separate project that may also not be completed before the revenue proposals are implemented for the reasons explained above.

   (d) Improving the onerous test in the revenue proposals to address application difficulties better achieves the objective of convergence in measuring contracts with customers by identifying and recognizing losses for similar onerous contracts.

Question 1: Including an onerous test in the revenue standard
Do the Boards agree that an onerous test should be included in the revenue standard?

Improving the onerous test in the revenue proposals

19. Although many respondents disagreed with the complexities of the onerous test proposed in the 2011 Exposure Draft, the Boards tried to ensure that the test provided useful information to users and did not identify contracts as onerous when those contracts were not truly economically burdensome. When considering improvements to the onerous test, the staff highlight that it may be necessary to make a combination of changes to achieve those objectives. The staff considered the following improvements to the onerous test:

(a) Modifying the scope of the onerous test to apply to all performance obligations;

(b) Changing the unit of account for the test such that it would apply to:

- (i) the contract (that is, the aggregate of the *remaining* performance obligations in a contract), and
- (ii) in some circumstances, multiple contracts, when those contracts are satisfied by a single event; and

(c) Modifying the measurement of the test by:

- (i) incorporating the notion of economic benefits into the test (replacing the transaction price), and/or,
- (ii) limiting the costs to be included in the test to be those that are incremental to the contract.

Modifying the scope of the onerous test to apply to all performance obligations

20. The 2011 Exposure Draft limited the scope of the onerous test to performance obligations satisfied over time and over a period of time greater than one year. The reason for that limited scope was to:

    (a) ease the practical application of the onerous test by making it closer to the scope of existing standards that specify an onerous test (ie IAS 11 *Construction Contracts* and Subtopic 605-35 *Construction-Type and Production-Type Contracts)*;

    (b) minimize the possibility of recognizing onerous losses on shorter duration contracts when such losses may not be meaningful; and

    (c) reflect the fact that performance obligations that are satisfied at a point in time typically result in the creation of an asset that would be subject to impairment testing in other standards (eg Subtopic 330-10-35 *Inventory – Subsequent measurement* and IAS 2).

21. Respondents disagreed with the proposal to limit the scope of the onerous test because they thought it created complexity. This is because loss recognition guidance for contracts with customers would differ depending on when and how the performance obligation is satisfied. Those respondents also disagreed with the proposed scope of the onerous test for the following reasons:

    (a) Many disagreed with excluding performance obligations that are satisfied at a point in time from the scope of the onerous test because they thought that the impairment tests in the inventory standards would not adequately capture losses on performance obligations satisfied at a point in time.

    > As per paragraph D21[1], rights and obligations arising from contracts with customers are to be completely scoped out of IAS 37. Given this, we believe that the proposed requirements for onerous provisions in the Exposure Draft are inadequate as they do not clearly cover performance obligations that an entity satisfies at a single point in time. For example, a car manufacturer enters

[1] Paragraph D21 in the IASB 2011 Exposure Draft proposed a consequential amendment to the scope of IAS 37.

> into an agreement to produce and sell 50 cars in 3 years' time. The manufacturer does not have any raw materials on hand at the time of entering into the contract and does not intend to purchase those materials until the production commences in one year's time. In the meantime, the price of steel dramatically increases resulting in the unfulfilled performance obligations becoming onerous. Under the current IAS 37 the manufacturer would be required to book an onerous contract provision in the first year. However, as the Exposure Draft is silent on this issue, there is no inventory to be impaired under IAS 2, and all revenue contracts are to be scoped out of IAS 37, it seems that under the revised requirements an onerous provision would not be necessary or even permitted. In our view, this would not be appropriate accounting for such a scenario.(CL#163 Hong Kong Institute of Certified Public Accountants)

(b) Other respondents explained that limiting the scope of the test to performance obligations satisfied over time and over a period of time greater than one year also created complexity because of the system changes that would be needed to separate performance obligations based on the timing of their satisfaction. Furthermore, some respondents also commented that the one-year scope limitation would lead to inconsistent recognition of losses on two equally onerous performance obligations because an entity would be required to recognize a loss on a performance obligation that is initially expected to be satisfied over a 13 month period but not for a performance obligation that is expected to be satisfied over an 11 month period.

> The exemption to record liabilities for onerous performance obligations only for contracts with expected durations greater than 1 year at inception is arbitrary and would not provide investors with timely information on contract performance. We believe that a scenario where a company would not record a material loss on a contract in an interim period because that contract was short-term is not transparent financial reporting. We recommend that the exemption for performance obligations satisfied over a period of time less than one year be removed so the focus is on liabilities at the end of the reporting period. (CL#46 Accenture)

Staff recommendation

22. To address these concerns the staff recommend that the Boards expand the scope of the onerous test to apply to *all* performance obligations, including those satisfied at a point in time and those satisfied over time and over a period of time less than one year. The staff recommend this change to simplify the onerous test

and remove the arbitrary differences created by the scope limitation in the 2011 Exposure Draft. In addition, the staff observe that other improvements to the test can address the concerns that the scope limitation in the 2011 Exposure Draft was designed to address (ie ensuring that the onerous test does not identify contracts as onerous that are not economically burdensome – see paragraphs 399 to 62261). Furthermore, the staff observe that the scope limitation in the 2011 Exposure Draft did not address the concerns related to the unit of account which is discussed in the next section.

Question 2: Scope of the onerous test
Do the Boards agree that the onerous test should apply to all performance obligations?

Changing the unit of account

23. Although a few respondents agreed with recognizing an onerous loss at the same unit of account (ie the performance obligation) that is used to determine when revenue is recognized, most respondents disagreed with the proposals to perform the onerous test at the performance obligation level. Similar feedback was received on the 2010 Exposure Draft that also proposed the performance obligation as the unit of account for the onerous test.

24. The Boards decided to keep the unit of account of the test at the performance obligation level in the 2011 Exposure Draft because:

    (a) a different unit of account would add complexity and would be inconsistent with recognizing revenue at the performance obligation level; and

    (b) specifying the contract as the unit of account could be arbitrary because the unit of account would depend on whether the entity provides its goods or services in one contract or in more than one contract.

25. However, respondents highlight that performing the onerous test at the performance obligation level is inconsistent with existing requirements that apply the onerous test at the contract level (eg Subtopic 605-35, IAS 11, and IAS 37).

26. Respondents also disagreed with the Boards' rationale described in the Basis for Conclusions for not changing the unit of account. Respondents did not think that performing the test at the contract level would add additional complexity and instead explained that they thought it would better reflect how management prices their contracts and views their business, which typically is at the contract level or above the contract level.

27. Accordingly, many argued that it would be counterintuitive to recognize a loss on a single performance obligation when the contract as a whole (or a portfolio of related contracts) is expected to be profitable. For instance, entities often price part of the contract at a loss in order to secure the contract and generate sales of other profitable goods or services within the contract (or within a portfolio of contracts). In addition, some noted that often costs are not tracked at the performance obligation level and doing so for the purposes of the onerous test may cause unnecessary complexity.

> We note that in paragraph BC207, the Boards considered but rejected changing the unit of account for the onerous test because they thought that it would add complexity; that it is inconsistent with recognizing revenue at the performance obligation level; and that the contract level is arbitrary. While we appreciate the scope modification of the onerous test, moving to a lower unit of account will be more complex versus tracking at the contract level. Tracking costs at the performance obligation level would require additional resources to allocate costs to each obligation. For contracts that are profitable overall, this cost would outweigh the benefits. For these types of contracts, we disagree that using the contract level view is inconsistent as profitability would still be reasonably assured at the completion of an arrangement. Further, because costs and potential loss contracts are continually monitored at an overall arrangement level, this would not reflect management's view. Therefore, for our company, the performance obligation level is arbitrary. (CL#26 IBM Corporation)

28. The staff suspect that in suggesting the Boards apply the onerous test at the level of the contract, many respondents mean that the unit of account for the onerous test should be the whole contract (including any satisfied or partially satisfied performance obligations). However, the staff think that the contract level should

be described as the aggregate of the *remaining* performance obligations in the contract. In the staff's view, it is necessary to perform the test on the aggregate of the remaining performance obligations in the contract to be consistent with the model which recognizes revenue on the basis of when performance obligations are satisfied and also to provide useful information for users. Consider the following example:

> **Example 1**
>
> An entity enters into a 5-year contract to provide the customer with two products and a service (ie the contract includes 3 performance obligations). The entity transfers the two products to the customer in Year 1 and recognizes revenue. The entity satisfies the performance obligation related to the service in Years 1 to 5 and recognizes revenue for the service as that service is provided to the customer. In Year 3, there is an increase in the entity's costs in providing the service. The entity concludes that the remaining costs of providing the service are higher than the remaining transaction price allocated to that service. However, the entity observes that the contract is still profitable overall because the expected losses on the remainder of the service are less than the profits previously recognized.

29. If, in Example 1, the unit of account for the onerous test was the whole contract, and required the entity to also assess the satisfied and partially satisfied performance obligations, no onerous loss would be recognized in Year 3 when the aggregate of the remaining performance obligations in the contract became loss-making. In the staff's view, this result would be inappropriate, and furthermore, not useful to users.

Staff recommendation

30. The staff recommend changing the unit of account for the onerous test to the contract level, specifically to the aggregate of the remaining performance obligations in the contract. Although this articulation would be different from IAS 11 and Subtopic 605-35, the staff understand it would be consistent with how current guidance is interpreted and applied in most cases.

31. Applying the onerous test to the aggregate of the remaining performance obligations in the contract would mean that the onerous test would be applied to a different unit of account than is used to recognize revenue. However, the staff think it is appropriate to change the unit of account to apply the onerous test to the aggregate of the remaining performance obligations because it would:

(a) produce more useful results for users because in most cases, management assesses profitability at the contract level;

(b) be consistent with how the entity negotiated with the customer;

(c) ease some practical concerns about allocating costs to performance obligations (including any costs to obtain a contract that have been capitalized).

32. The staff also observe that respondents to the 2010 and 2011 Exposure Drafts have consistently opposed recognizing losses for individually onerous performance obligations when the contract as a whole is profitable.

33. However, the staff observe that in addition to changing the unit of account for the onerous test to the contract level (that is, the aggregate of the remaining performance obligations in the contract) the Boards will need to consider other modifications to the onerous test (discussed below). This is because, in some cases, entities price their contracts and assess profitability based on a unit of account higher than the individual contracts (ie a flight or a route). This was highlighted by some responses received during the redeliberations of the 2010 Exposure Draft when the Boards tentatively agreed to move the unit of account to the contract level (that is, the aggregate of the remaining performance obligations in the contract).

34. For instance, in response to the tentative decision to change the unit of account to the contract, respondents from the airline industry highlighted that many of their contracts would be identified as onerous. This may occur because, for example, the first seat on a flight is heavily discounted and thus may be identified as loss-making under the proposals. Those respondents explained that they price their contracts (ie seats) at a level above the contract, usually at the level of the flight or

even higher at the route level. Thus, in their view, recognizing losses on seats when they are sold (ie in advance of performance) would be inappropriate and furthermore it would not be useful to users, because those losses would effectively be reversed and greater profits would be recognized when performance occurs (that is, when the flight is flown). These examples caused the Boards to reconsider their initial tentative decision in the redeliberations of the 2010 Exposure Draft to change the unit of account for the onerous test to the contract level and led to the proposal to limit the scope of the onerous test as defined in the 2011 Exposure Draft (as discussed in paragraphs 20 to 22 above).

35. One way to address the issue when profitability is assessed at a level above the contract is to permit entities, in limited circumstances, to apply the test to a higher unit of account. Specifically, when a number of contracts are satisfied by a single event or single act of performance by the entity.

Unit of account: multiple contracts satisfied by a single event

36. Applying the onerous test to a unit of account above the contract would produce more useful results when entities assess profitability at a higher unit of account. For example, defining that unit of account to allow entities to apply the onerous test to multiple contracts that are satisfied by a single event would alleviate concerns for the airline industry (as mentioned above). In addition, it would also produce more useful results in the following circumstances where profitability is assessed above the contract level:

(a) Media and entertainment industry (eg tickets for a show, play, concert, etc.)

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

(c) Passage on a cruise ship

(d) Magazine subscriptions and related advertising

37. However, while that unit of account would address the above examples, it may require entities to recognize losses before performance in the following situations:

(a) Airline industry – flight repositioning – an airline who sells a seat on an unprofitable flight that is flown to reposition the plane for a profitable flight (eg a late night flight from Montreal to New York City at a loss in order to reposition the flight for an early morning flight back to Montreal that makes a profit),

(b) Media and entertainment – episodic television or film production – in many cases the costs that relate directly to producing a television series or a film (that is, including amortization of any capitalized production costs) will be recovered through multiple contracts that are obtained over a period of time.

38. Therefore, the staff do not think that applying the onerous test to multiple contracts that are satisfied by a single event appropriately addresses all situations where profitability is assessed above the contract level. Accordingly, the staff think that other modifications to the onerous test must be considered. In the next part of the paper the staff recommend addressing the examples noted above by modifying the measurement of the onerous test. Given this, the staff do not recommend changing the unit of account to above the contract level for multiple contracts that are satisfied by a single event. In addition, the staff think that applying the test to multiple contracts in such circumstances may create unnecessary complexity.

Question 3: Unit of account

Do the Boards agree that:

(a) the onerous test should be applied to the aggregate of the remaining performance obligations in the contract; and

(b) the onerous test should not be applied to multiple contracts satisfied by a single event?

Modifying the measurement of the test

39. The 2011 Exposure Draft proposes that an entity recognize an onerous liability when the lowest cost of settling the performance obligation (see paragraph 6) exceeds the amount of the transaction price allocated to that performance obligation. Furthermore, that onerous liability would be measured at the amount at which those costs exceed the transaction price.

40. A small number of respondents raised concerns about the notion of 'lowest cost of settling' because, typically, an entity cannot exit from a single performance obligation but instead can exit from only the whole contract. Thus, using the amount that the entity would pay to exit the performance obligation to measure the onerous loss in their view would not be representative of how the contract would be settled. In addition, others noted that in some cases it may be a common and rational practice for an entity to decide to settle an onerous performance obligation with performance, even if it would be less costly to exit that performance obligation. In that situation, a few respondents questioned whether an entity should be allowed to consider what it would pay to exit the performance obligation in the measurement of the onerous liability only if the entity actually intends to exit the performance obligation.

41. The concern about not being able to exit the performance obligation would be addressed if the Boards decide to change the unit of account to the aggregate of the remaining performance obligations in the contract (see paragraphs 23 to 35). However, the staff do not think a change is necessary to address the remaining concern. This is because the lowest cost notion is an objective assessment that requires an entity to compare the costs of satisfying the aggregate of the remaining performance obligations to the costs that they would have to pay if they were permitted to exit. This notion is similar to that in IAS 37 (ie 'the least net cost of exiting') and is helpful as an identification criterion to ensure that only contracts that are truly economically burdensome are identified as onerous. The staff considered retaining the lowest cost of settling notion for the purposes of identifying an onerous loss but modifying that notion for the purposes of measuring onerous losses. The staff rejected this option because a different

identification and measurement principle would create an inconsistency that adds unnecessary complexity to the onerous test.

42. In addition to that feedback, others commented on other parts of the measurement of the onerous test, including the limitations of considering only the transaction price in the measurement of the test and including all direct costs. Respondents highlight that these factors may either inappropriately:

(a) identify some contracts as onerous that are beneficial to the entity, or

(b) accelerate the recognition of future expenses that would have been incurred regardless of whether the entity entered into the contract.

43. Given that feedback and the consequences of modifying the scope and unit of account of the onerous test on the examples provided above, the staff considered the following options for changing the measurement of the onerous test. One alternative modifies the 'inflows' (benefits considered) used in the onerous test and the other modifies the 'outflows' (costs considered):

(a) change "inflows" – consider other economic benefits received from the contract, instead of only the transaction price, and/or

(b) change "outflows" – limiting the costs to be included in the test to be those that are incremental to the contract.

Economic benefits

44. One of the options for changing the measurement of the onerous test is to change the 'inflows' that would be considered in the onerous test so as to enable an entity to consider other benefits that may be received as a result of entering into a single contract rather than just the transaction price, as proposed in the 2011 Exposure Draft. This might be useful in circumstances in which the entity assesses profitability at a level above the contract.

45. These benefits could be described as 'economic benefits,' which is the term used to assess inflows in the onerous test in IAS 37 (ie paragraph 10 of IAS 37 defines an onerous contract as "a contract in which the unavoidable costs of meeting the

obligations under the contract exceed the *economic benefits* expected to be received under it”).

46. The term ‘economic benefits’ is not defined in IAS 37 and the application of that term in the onerous test largely comes from external guidance. This external guidance suggests various interpretations of the term, but some of that guidance may result from the broad scope of contracts that are included in IAS 37. One interpretation defines economic benefits in a wide sense and permits entities to look beyond the contract to other benefits expected to be received. This may include future revenue generating events, benefits from a customer relationship and other benefits received directly or indirectly under the contract. This interpretation seems broadly consistent with the term ‘future economic benefits’ that is defined in paragraph 4.8 of the IASB Conceptual Framework in relation to the definition of an asset as “the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity…or a capability to reduce cash outflows.”

47. However, other guidance seems to suggest that ‘economic benefits’ should be interpreted narrowly and thus only economic benefits received directly under the contract would be considered.

48. To ensure consistent application, incorporating the term ‘economic benefits’ in the onerous test in the revenue standard may require the Boards to provide additional guidance on the definition of the term and how to apply it to contracts with customers. In the staff’s view, defining the term and how it should be applied will be difficult. This is because, to ensure the onerous test provides useful information, the Boards will need to define the application of the term economic benefits to be wide enough to encompass benefits received from engaging in a contract, but narrow enough to exclude those benefits that are unrelated, improbable, and are not likely to be received. For example, economic benefits could encompass:

(a) the transaction price,

(b) other profitable contracts that are directly related to the contract,

(c) future related events or contracts that are likely to occur and that will result in either:

   (i) direct or indirect inflows of cash and cash equivalents, or

   (ii) a reduction in future cash outflows.

49. The staff observe, however, that irrespective of what guidance is provided, stakeholders may raise additional questions as to how the guidance provided in the revenue proposals relates to the application of the same term (ie ‘economic benefits’) in the onerous test in IAS 37. In light of this implication, the staff considered using a different term. However, the staff thought that selecting a different term would also raise further questions and possibly cause confusion as it may be unclear why the Boards selected a different term to describe broadly similar notions.

50. Given these implications, the staff do not recommend modifying the measurement of the test to incorporate the notion of ‘economic benefits’.

Incremental costs

51. The other aspect of the measurement of the test that could be modified is the costs (or potential outflows) to be included in the test. Currently, the costs that are included in the test are the lowest cost of settling the performance obligation, which is the lower of the costs that relate directly to satisfying the performance obligations (as defined in paragraph 92 of the 2011 Exposure Draft) and the amount the entity would pay to exit the performance obligation. This option considers whether the costs that relate directly to satisfying the performance obligation should be modified to include only those incremental to satisfying the aggregate of the remaining performance obligations in the contract, given the staff recommendation in paragraph 30 above.

52. In the 2011 Exposure Draft, the costs that relate directly to satisfying the performance obligation were described in paragraph 92 as follows:

(a) Direct labor (for example, salaries and wages of employees who provide services directly 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 to contract activities (for example, costs of contract management and supervision, insurance, 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 are incurred only because the entity entered into the contract (for example, payments to subcontractors).

53. A few respondents disagreed with the extent, or type, of costs used in the onerous test and in measuring the onerous liability. In their view, some of those costs would be incurred regardless of entering into the contract and therefore recognizing them as an onerous liability would be accelerating the recognition of future operating expenses (ie recognizing future operating losses). Given this, those respondents suggest that the costs included in the onerous test should be limited to the costs that are incremental to satisfying the performance obligations in the contract. One respondent explained:

> Only incremental costs directly related to a performance obligation should be considered when determining the lowest cost of settling a performance obligation. If non-incremental costs are included in this determination, we believe there may be unintended consequences in which the signing of an otherwise profitable contract could result in a day-one onerous performance obligation. For example, an entity may enter into a low-margin contract (when considering just the incremental costs to be incurred) in situations in which they currently have fixed labor with excess capacity. In addition, a development stage entity may enter into low margin contracts as it is ramping up its business. When considering other costs like the allocation of direct labor costs that are fixed, the lowest cost of settling a performance obligation may be in excess of the transaction price allocated to the performance obligation, which would result in recognizing an onerous performance obligation. However, if the entity does not sign the low margin contract, those same fixed labor costs would be simply recognized as an expense as incurred. As we believe this result does not reflect the economics of this type of transaction, we believe only the incremental costs should be considered when determining the lowest cost of settling a performance obligation. (CL#205 RSM International)

54. The incremental costs in a contract can be defined as those that an entity "would not have incurred if the contract had not been entered into" (paragraph 95 of the 2011 Exposure Draft). Furthermore, incremental costs are unavoidable and directly variable with satisfying the performance obligations in the contract. In addition, incremental costs would not include allocated or shared costs that will be incurred regardless of whether the entity fulfils the contract or not.

55. As indicated in the comment in paragraph 53 above, considering only the incremental costs in identifying and measuring an onerous loss would provide more useful information because contracts that recover at least those costs are not identified as onerous. In outreach, some users agreed that these contracts should not be identified as onerous (and therefore a loss should not be recognized before performance) because generally these contracts are beneficial to the entity. Furthermore, any fixed costs generally result from assets, or long-term purchase contracts which are tested for impairment and as onerous contracts under other standards. In addition, the impairment tests related to these (and other) assets would be completed prior to any onerous loss being recognized.

56. The staff acknowledge that including only the incremental costs in the onerous test may cause a difference in the timing of recognition of losses for entities with different costs structures. This is because, all other things being equal, an entity with a higher fixed cost base may not identify as many contracts as onerous as another entity with high incremental costs. Effectively, this means that an entity with highly variable costs will recognize onerous losses in advance of performance, however an entity with high fixed costs (but no impairment of assets) will recognize 'losses' (after considering the fixed costs) at the time of performance. However, the staff also acknowledge that the converse will be true for impairment losses and thus limiting the costs in the onerous test will provide useful information for users.

57. Furthermore, the staff observe that limiting the costs to be included in the test will also provide more useful information for a number of the contracts explained above, such as when profitability is assessed at a level above the contract. This is because, in the examples highlighted above, an onerous contract would only be

identified when that contract did not cover the incremental costs of entering into that contract. Thus acknowledging that some of the fixed costs may be recovered in other ways such as through other contracts satisfied at the same time (eg seats on a flight, theatre tickets, shipping containers, and passage on a cruise ship) and through other contracts with the customer or a broader pool of customers (eg flight repositioning and media and entertainment). (The staff observe however that this approach would not defer any fixed costs, which would be recognized when those contracts are satisfied.) Consider the following example:

Example 2

An airline sells a seat on a plane from Montreal to New York City. The ticket price covers the variable portions of the flight directly attributable to it (eg the costs of the fuel and food that would not have been incurred but for the sale of that seat). The ticket price also covers a small portion of the fixed costs (ie the amortization of the plane). The flight is flown to reposition the plane in New York City for an outgoing flight the next morning which will be profitable. The flight would be flown regardless of whether the airline sold any seats on that flight.

The airline views the single seat it has sold as a contract that is beneficial to its operations because the ticket price recovers the incremental costs directly related to it, as well as a small portion of the costs the airline would have incurred regardless of selling that seat (that is, because it needed to reposition the plane on a profitable route for the first flight of the next day). Requiring the airline to recognize a loss when the seat is sold and in advance of flying the plane would not be consistent with how management assesses profitability and would not provide useful information for users. (Note that the full costs of flying the plane would be recognized when that flight is flown.)

58. In addition, limiting the costs to be considered in the onerous test eliminates the difficulties that many entities may encounter in determining how to allocate a portion of the costs related to fixed assets to individual contracts (for the purposes of the onerous test). This is particularly difficult and evident in industries with a significant amount of capitalized assets, such as media and entertainment, when those costs may be recovered over a number of contracts, over a number of years.

59. Limiting the costs to those that are incremental to satisfying the aggregate of the remaining performance obligations in the contract is also consistent with what many have interpreted to be the costs that should be included in the onerous test in IAS 37 (ie the 'least net cost of exiting the contract'). This is because including only the incremental costs in the measurement of any onerous losses will ensure that an entity does not accelerate the recognition of future operating costs that would normally be expensed as incurred (something which is specifically prohibited under IAS 37).

60. Some in the construction industry may also raise concerns that defining costs as those that are incremental to the contract is a change to the existing requirements for recognizing onerous losses in Subtopic 605-35 and IAS 11. Furthermore those costs are likely to be different from those that may be used in an input method for measuring progress (eg a cost to cost method) and thus may create additional work or systems changes for the purposes of identifying onerous contracts. However, the staff think that this modification to the costs in the identification and measurement of onerous losses is necessary to accommodate the broader spectrum of contracts that will be applying this test in the revenue proposals.

Staff recommendation

61. The staff recommend refining the requirements for identifying and measuring onerous losses to include only those costs that are incremental to satisfying the aggregate of the remaining performance obligations in the contract.

62. Therefore, in assessing whether a contract is onerous, an entity would compare the transaction price allocated to the aggregate of the remaining performance obligations to lowest cost of settling those performance obligations which would be the lower of the following:

    (a) The costs that are incremental to satisfying the aggregate of the remaining performances obligations in the contract, or

(b) The amount the entity would pay to exit the contract, if the entity was permitted to do so, other than by transferring the promised goods or services.

Question 4 – Modify the measurement of the test
Do the Boards agree that the costs considered in identifying and measuring onerous contracts should be the lower of the following: (a) The costs that are incremental to satisfying the aggregate of the remaining performances obligations in the contract, and (b) the amount that the entity would have to pay to exit the contract, if the entity was permitted to do so, other than by transferring the promised goods or services.

(FASB only) Applying the onerous test to not-for-profit entities

63. The 2011 Exposure Draft proposed an exception to the onerous test for not-for-profit entities that enter into a contract for the purpose of providing a social or charitable benefit (paragraph 90 in the 2011 Exposure Draft). Many not-for-profit respondents agree with this proposal. However, many of those respondents request further clarification about the intent of the guidance. For example, most not-for-profit entities have a stated mission of providing some form of social or charitable benefit that is either explicit or implicit to every contract. Therefore, those respondents stated that all of their contracts contribute in some way to their stated purposes of providing a social or charitable benefit.

64. The staff recommend that the FASB clarify that the assessment of whether a contract can be excluded from the onerous test should be completed at the contract level, with an understanding of the objective and circumstances associated with that individual contract (narrower scope), rather than considering the overall mission of the entity (broader scope).

Question 5 – Not-for-profit entities
Does the FASB agree with the staff recommendation that the original intent was a narrow, contract-based assessment and therefore agrees with the clarification proposed?

Appendix A: Suggested changes

A1. The following table lists the proposed requirements from the 2011 Expose Draft that relate to identifying and measuring an onerous loss (ie the onerous test) and identifies which of those proposals might change as a result of the staff recommendations in this paper.

Proposals from the 2011 Exposure Draft	Suggested changes
86 For a performance obligation that an entity satisfies over time (see paragraphs 35 and 36) and that the entity expects at contract inception to satisfy over a period of time greater than one year, an entity shall recognize a liability and a corresponding expense if the performance obligation is onerous.	The staff recommend a change in paragraphs 22 and 30 of this paper. The staff recommend that the onerous test would apply to all performance obligations (ie performance obligations satisfied at a point in time and performance obligations satisfied over time, including those satisfied over a period of time less than one year). The staff also recommend changing the unit of account to the aggregate of the remaining performance obligations in the contract. This change would be made throughout this section where there is currently a reference to 'performance obligation'.
87 A performance obligation is onerous if the lowest cost of settling the performance obligation exceeds the amount of the transaction price allocated to that performance obligation. The lowest cost of settling a performance obligation is the lower of the following amounts:	The staff recommend a change in paragraph 61 of this paper. Specifically, the staff recommend changing paragraph 87(a) to the costs that are incremental to satisfying the aggregate of the remaining performance obligations in the

	(a) the costs that relate directly to satisfying the performance obligation by transferring the promised goods or services (those costs are described in paragraph 92); and (b) the amount that the entity would pay to exit the performance obligation if the entity is permitted to do so other than by transferring the promised goods or services.	contract.
88	An entity shall initially measure the liability for an onerous performance obligation at the amount by which the lowest cost of settling the remaining performance obligation exceeds the amount of the transaction price allocated to that remaining performance obligation. At each reporting date, an entity shall update the measurement of the liability for an onerous performance obligation for changes in circumstances. An entity shall recognize changes in the measurement of that liability as an expense or as a reduction of an expense. When an entity satisfies an onerous performance obligation, the entity shall derecognize the related liability.	No material change to this paragraph.
89	Before an entity recognizes a liability for an onerous performance obligation, the entity shall apply the requirements in paragraphs 100–103 to test for impairment of an asset recognized from the costs incurred to obtain or fulfil a contract with a customer.	This paragraph should be clarified to indicate that an entity should apply an impairment test to *all* assets related to the contract before applying the onerous test in the revenue standard (see paragraph 5).
90	*[FASB only]* A not-for-profit entity shall not recognize a liability for an onerous performance obligation if the purpose of the contract is to provide a social or charitable benefit.	The staff recommend a clarification to this paragraph in paragraph 63.