

STAFF PAPER

December 2017

IASB Meeting

Project	Costs considered in assessing whether a contract is onerous (IAS 37)		
Paper topic	Interpretations Committee decisions		
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Introduction and purpose

1. At its November 2017 meeting, the IFRS Interpretations Committee (Committee) decided to add a project to its standard-setting agenda to clarify the meaning of the term ‘unavoidable costs’ in the IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* definition of an onerous contract.
2. The Board has a wider project on IAS 37 in its research pipeline. The purpose of this research project will be to decide whether to add to the Board’s standard-setting agenda a project to amend aspects of IAS 37 and, if so, what the scope of that project should be. The matter being addressed by the Committee is one that the Board has previously identified for consideration within its research project.
3. The purpose of this paper is to inform the Board of the Committee’s project and to give Board members an opportunity to comment on the Committee’s decisions and planned next steps.

Issue being addressed

4. The Committee received a request to clarify the costs an entity considers when assessing whether a contract is onerous applying IAS 37. In particular, the submitter asked about the application of IAS 37 to contracts with customers that were previously within the scope of IAS 11 *Construction Contracts*. For financial periods beginning on or after 1 January 2018, such contracts will be within the scope of IFRS 15 *Revenue from Contracts with Customers*.

5. IAS 11 contained specific requirements on the costs an entity includes and does not include in identifying, recognising and measuring an onerous contract liability for contracts that were in its scope.

6. In contrast, IFRS 15 does not include requirements for identifying and measuring onerous contract liabilities. Instead, as noted in paragraphs 5(g) of IAS 37 and BC296 of IFRS 15, an entity applies paragraphs 66–69 of IAS 37 in assessing whether a contract to which it applies IFRS 15 is onerous. Accordingly, the Committee concluded that, when determining which costs to include in assessing whether such a contract is onerous, the entity does not apply the previous requirements in IAS 11 on contract costs, and nor does it apply the requirements in IFRS 15 on costs that relate directly to a contract. Instead, the entity applies the definition of an onerous contract in IAS 37.

7. 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. Paragraph 68 of IAS 37 states that the unavoidable costs under a contract are the lower of the cost of fulfilling the contract and any compensation or penalties arising from failure to fulfil it. However, IAS 37 includes no further requirements on which costs to include in measuring the costs of fulfilling a contract.

8. The Board has a project on IAS 37 in its research pipeline. Projects in the research pipeline are not currently active, but the Board expects to start, or restart, work on them before the next Agenda Consultation, which is expected to start around 2021. The Board has identified a variety of problems with IAS 37, including the diverse interpretations of the term ‘unavoidable costs’ for identifying onerous contracts (see [Agenda paper 14B](#) to the July 2015 Board meeting). However, the Board has not yet decided the extent and nature of any standard-setting that it may undertake. In addition, the Board’s project will not be completed (and may not even become active) for some time.

Previous Committee decisions

June 2017

9. In June 2017, the Committee noted two possible ways of reading ‘unavoidable costs’ in paragraph 68 of IAS 37:
 - (a) unavoidable costs are the costs that an entity cannot avoid because it has the contract. Such costs would include, for example, an allocation of overhead costs if those costs are incurred for activities required to complete the contract.
 - (b) unavoidable costs are the costs that an entity would avoid if it did not have the contract. Such costs are often referred to as ‘incremental costs’.

10. The Committee considered whether to add a project to its standard-setting agenda to eliminate one of the possible ways of reading the requirements. However, it decided that amendments could not be developed for some of the requirements on onerous contracts without conducting a comprehensive review of all those requirements. With this in mind, the Committee concluded that it would be unable to resolve the matter efficiently within the confines of existing IFRS Standards and decided not to add the matter to its standard-setting agenda. It published a tentative agenda decision identifying the two ways of reading the requirements and explaining its conclusions.

September 2017

11. Eleven of the 12 respondents to the tentative agenda decision opposed it, taking the view that the Committee should undertake narrow-scope standard setting to reduce to one the possible ways of reading the term ‘unavoidable costs’. Respondents said the impending application of IFRS 15 made standard-setting particularly necessary and urgent.

12. In September 2017, the Committee re-considered its tentative agenda decision in the light of this feedback and the uncertain scope and timescale of the Board’s project on IAS 37. The Committee also noted that a possible project to clarify the term ‘unavoidable costs’ in paragraph 68 of IAS 37 could be a discrete project that encompasses only a small part of the Board’s wider project, and thus should be capable of being completed on a more timely basis.

13. Taking all these factors into account, the Committee decided to research possible narrow-scope standard-setting to clarify the term ‘unavoidable costs’.

Latest Committee decisions and planned next steps

November 2017

14. In November 2017 the Committee considered the feasibility and scope of possible narrow-scope standard setting to address the questions raised in the request.
15. The Committee decided to add a project to its standard-setting agenda to clarify the meaning of the term ‘unavoidable costs’ in the IAS 37 definition of an onerous contract.
16. The Committee also reached decisions on the scope of the project. It decided that:
 - (a) any new requirements should apply to all onerous contracts within the scope of IAS 37, not only contracts within the scope of IFRS 15;
 - (b) the scope of the project should be restricted to clarifying the requirements for identifying onerous contracts. The scope should not include adding requirements for measuring onerous contracts; and
 - (c) the scope of the project should be to clarify only the term ‘unavoidable costs’ in the IAS 37 definition of an onerous contract—the scope should not include clarifying other aspects of the definition, such as the meaning of the phrase ‘economic benefits expected to be received’.

Planned next steps

17. At a future meeting the Committee will consider the technical issues—alternative ways of interpreting the term ‘unavoidable costs’ and the requirements needed. The Committee has decided to consider these matters before deciding whether any new requirements it recommends should take the form of an Interpretation or a narrow-scope amendment to IAS 37.

Question for the Board

Question for Board members

Do you have any comments on, or questions about, the Committee's decisions and planned next steps?