In brief

Onerous contracts

Proposals to clarify IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

The International Accounting Standards Board (Board) proposes to specify in IAS 37 that, in assessing whether a contract is onerous, companies should include all costs that relate directly to the contract, not only the incremental costs. This clarification could particularly affect construction, manufacturing and service companies.

Chungwoo Suh, a member of the Board, explains what the Board is proposing and why.

What is an onerous contract?

IAS 37 defines an onerous contract:

Onerous contract

A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

IAS 37 also explains what unavoidable costs are:

Unavoidable costs

The lower of the **cost of fulfilling the contract** and any compensation or penalties arising from failure to fulfil it.

A contract can be onerous from its outset, or it can become onerous when circumstances change and expected costs increase or expected economic benefits decrease.

How do companies report onerous contracts?

As soon as a contract is assessed to be onerous, a company applying IAS 37 records a provision in its financial statements for the loss it expects to make on the contract.

What's unclear?

IAS 37 does not specify which costs to include in estimating the cost of fulfilling a contract. People have reached different views on whether to include:

- only the **incremental costs** of fulfilling that contract—for example, the cost of materials and labour required to construct a building; or
- all **costs that relate directly to the contract**—both the incremental costs and an allocation of other costs that relate directly to contract activities. For example, a company may include an allocation of:
  - the depreciation charge for equipment the company uses to construct buildings; and
  - the salary of a contracts supervisor.

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Why is the Board acting now?

Recent changes to other IFRS Standards mean that these differing views could cause greater diversity in reporting practices in the future than they have done in the past.

The Board recently withdrew the previous IFRS Standard for construction contracts, IAS 11. From now on, companies will apply IFRS 15 *Revenue from Contracts with Customers* to construction contracts.

IFRS 15 does not specify how to account for onerous contracts. Instead, IFRS 15 directs companies to apply the general onerous contract requirements in IAS 37.

The previous Standard for construction contracts required companies to include both incremental costs and other costs that relate directly to contract activities in measuring contract costs. Construction companies' financial statements would become less comparable if these companies took different views on how to apply IAS 37.

If a construction company decided to include only incremental costs in determining the cost of fulfilling a contract, it would have changed its policy to one that is less likely to give early warning of expected contract losses than its previous policy applying the previous Standard.

Stakeholders have raised concerns, prompting us to act to clarify the requirements in IAS 37.

If a construction company decided to include only incremental costs it would be less likely to give early warning of expected contract losses.

Why do views vary?

Some people say that for a company to faithfully represent its obligations under a contract, it must account for the full costs of fulfilling those obligations. Others say that requirements in IAS 37 prevent companies from including any costs beyond incremental costs. They suggest that:

- the cost of resources shared across several contracts will be incurred by the company regardless of whether it fulfils the contract under consideration. These costs are therefore not costs of 'fulfilling the contract'—they are costs of operating the business. IAS 37 does not allow companies to record provisions for 'costs that need to be incurred to operate in the future'.
- the 'unavoidable' costs of a contract are the costs the company could avoid if the contract did not exist—in other words, only the incremental costs.

What is the Board's view?

The Board does not agree that IAS 37 prevents companies from including costs shared across several contracts. In our view:

- by including an allocation of such costs in determining the cost of fulfilling a contract, a company is not recording a provision *for* those future costs. Instead, it is recording a provision for its obligation to deliver goods and services under an existing contract and *measuring* that obligation to reflect the cost of the goods or services it must deliver.
- the 'unavoidable' costs of fulfilling a contract are the costs the company cannot avoid because of the contract's existence—in other words, unavoidable costs comprise both incremental costs and an allocation of other costs that relate directly to contract activities.

It is also our view that there are reasons for including all costs that relate directly to a contract in assessing whether the contract is onerous.

Reasons for including all costs that relate directly to a contract

- **Faithful representation**—a company may obtain the resources it needs to fulfil a contract in different ways. For example, it may hire equipment for use only for that contract or buy equipment for use on several contracts. A company incurs costs regardless of the way it obtains resources—including only incremental costs would fail to record the cost of resources shared with other contracts.
- **Consistency with other IFRS Standards**—IFRS 17 *Insurance Contracts* requires insurers to include all costs that relate directly to the fulfilment of a contract, including an allocation of fixed and variable overheads, in assessing whether an insurance contract is onerous. Also, several IFRS Standards—such as IAS 2 *Inventories*—specify the costs to include in measuring a non-monetary asset. They all require companies to include both the incremental costs of purchasing or constructing the asset and an allocation of other directly related or directly attributable costs. The way a company determines the cost of fulfilling a contract to deliver goods should be consistent with the way it measures the cost of those goods when it holds them.
- **Reduced complexity**—a company may have contracts that appear individually profitable when only incremental costs are included but are loss-making as a group when other directly related costs are included. To ensure that individual contracts are identified as onerous, an incremental cost approach would need additional requirements on when to assess contracts as a group or individually. Such requirements could add complexity.
- **Providing relevant information**—including all costs that relate directly to a contract gives earlier warning of expected losses.

For these reasons, we have concluded that in determining the cost of fulfilling a contract, companies should include both the incremental costs and an allocation of other costs that relate directly to contract activities.

What is the Board proposing?

The Board proposes to amend IAS 37 to:

- specify that in assessing whether a contract is onerous, the cost of fulfilling the contract includes both the incremental costs and an allocation of other costs that relate directly to contract activities; and
- include examples of costs that relate and costs that do not relate directly to a contract.

What contracts will be affected?

The proposed amendments would apply to all contracts within the scope of IAS 37.

The Board considered suggestions that any new requirements should apply only to contracts within the scope of IFRS 15, or even only to construction contracts. Some stakeholders suggested that restricting the scope of new requirements in this way would address stakeholder concerns about construction contracts without forcing unnecessary change on companies with other types of contract.

However, we are proposing requirements that apply to all types of contract—not only construction contracts.

We have taken the view that requiring companies to apply the same requirements to all contracts within the scope of IAS 37 would enhance the comparability, and hence usefulness, of financial statements. We also noted that specifying requirements for all such contracts should reduce any existing diversity in the application of IAS 37.

If the Board were to specify requirements only for construction contracts, managers of companies applying IAS 37 to other types of contracts could face difficult questions. For example, if they adopted an accounting policy for those contracts different from the policy required by IAS 37 for construction contracts, they would need to consider whether and how they could justify that different policy.

Clarifying that IAS 37 does not require an incremental cost approach could help avoid a significant change in accounting practice for onerous construction contracts.

What are the implications?

Clarifying that IAS 37 *does not* require an incremental cost approach could help avoid a significant change in accounting practice for onerous construction contracts.

However, specifying that IAS 37 *does* require companies to include all directly related costs could change the way in which companies assess other types of contract. Companies that apply an incremental cost approach at present may record onerous contract costs earlier than they do at present.

What happens next?

The Board has set out its proposals in Exposure Draft *Onerous Contracts—Cost of Fulfilling a Contract* (Proposed amendments to IAS 37).

We welcome comments from all interested parties. We will consider all comments received by 15 April 2019 in deciding whether and how to finalise the amendments to IAS 37.

You can submit comments on the Open for Comment page of the IFRS Foundation website.

To download a copy of the Exposure Draft, read further information about the proposals or register to receive project updates

Visit the Onerous Costs—Cost of Fulfilling a Contract (Amendments to IAS 37) project page on the IFRS Foundation website.

To get in touch

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