



**30 Cannon Street, London EC4M 6XH, United Kingdom**  
**Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411**  
**E-mail: [iasb@iasb.org](mailto:iasb@iasb.org) Website: [www.iasb.org](http://www.iasb.org)**

**International  
Accounting Standards  
Board**

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*These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

## **INFORMATION FOR OBSERVERS**

**Board Meeting:** Wednesday 16 April 2008, London

**Project:** IAS 37 Short-term convergence amendments

**Subject:** Onerous contracts – comment analysis (Agenda Paper 5B)

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### **Introduction**

- 1 This paper provides an analysis of comments received on the proposed amendments for onerous contracts.

### **Difference between the current IAS 37 and the proposals in the Exposure Draft**

- 2 The differences in accounting treatment of onerous contracts between the current IAS 37 and the Exposure Draft can be summarised as follows:
  - (a) the Exposure Draft proposes that liabilities for contracts that become onerous due to an entity's own actions be recognised only when the entity has taken the action.
  - (b) the Exposure Draft explicitly clarifies that if the onerous contract is an operating lease, the entity determines the unavoidable cost by reference to the remaining lease rental payable, reduced by the estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease.

<b>Current IAS 37</b>	<b>Exposure Draft IAS 37</b>
<p data-bbox="252 230 676 405"><b>[IAS 37.66]</b> If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.</p> <p data-bbox="252 412 676 920"><b>[IAS 37.68]</b> This Standard 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. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.</p>	<p data-bbox="699 230 1359 443"><b>[ED IAS 37.55]</b> If an entity has a contract that is onerous, it shall recognise as a liability the present obligation under the contract. If the contract will become onerous as a result of the entity’s own actions, the entity shall not recognise the liability until it has taken the action.</p> <p data-bbox="699 488 1359 1144"><b>[ED IAS 37.57]</b> In some cases, contracts become onerous as a result of events outside the entity’s control. For example, a contract that requires an entity to make specified payments regardless of whether it takes delivery of contracted products or services may become onerous if the market price of the products or services declines below the contracted price. In other cases, the event that makes the contract onerous is an action of the entity. In such cases, the liability for the onerous contract is not recognised until the entity has taken the action. For example, a contract may become onerous because the entity ceases to use the right conveyed by that contract, but continues to incur costs for its obligations under the contract. Therefore, in this example the entity does not recognise a liability until it ceases using the right conveyed by the contract.</p> <p data-bbox="699 1182 1359 1648"><b>[ED IAS 37.58]</b> A contract is onerous when the unavoidable costs of meeting its obligations exceed its expected economic benefits. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. If the contract is an operating lease, the entity determines the unavoidable cost by reference to the remaining lease rentals payable, reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease.</p>

## Rationale for the proposed changes in the Exposure Draft

- 3 In US GAAP, there are no general requirements for onerous contracts similar to those in IAS 37. However, the Board noted that SFAS 146 *Accounting for Costs Associated with Exit or Disposal Activities* provides specific guidance for two classes of contract termination costs that under IFRSs would be likely to be classified as onerous contracts:
- (a) costs that arise from terminating a contract before the end of its term and
  - (b) costs that will continue to be incurred under a contract for its remaining term without equivalent economic benefit to the entity (for example, an operating lease of a vacant property).
- 4 In SFAS146 the liability for the former is recognised only when the decision to terminate the contract has been communicated to the counterparty and the entity has incurred a legal obligation under the contract for the penalty or other costs specified by the contract. The liability for the latter is recognised when the entity ceases to use the right conveyed by the contract.
- 5 In SFAS 146 the FASB has moved away from an intention-based approach for the recognition of contract termination costs. In contrast, in the context of a restructuring, the present requirements in IAS 37 would be likely to result in entities recognising liabilities for these onerous contracts on the basis of a commitment, or an intention, to restructure.
- 6 Questions relating to the timing of recognition of a liability for an onerous contract arise because there is no new obligating event that results in the entity incurring a present obligation. For example, in the case of an operating lease that satisfies the definition of an onerous contract, the entity's present obligation was, in fact, incurred when the entity entered into the lease. The contract becomes onerous because of an impairment in the value of the entity's rights, not a new obligation. The requirements relating to onerous contracts are necessary because the rights and obligations under executory

contracts and operating leases are not recognised under current accounting conventions. If they were recognised, any impairment of the value of the contract would be recognised by writing down the asset.

- 7 The Board noted that onerous contracts can be divided into two broad categories: those that become onerous because of factors outside the entity's control (for example, a take-or-pay contract in which the market price of the contracted product declines below the contracted price for that product) and those that become onerous because of the entity's own actions (for example, as a result of vacating a property). Therefore, the Board decided to adopt the recognition requirements of SFAS 146 by specifying that if a contract will become onerous as a result of the entity's own actions, the liability should not be recognised until the entity has taken that action. The Board believes that until the entity has undertaken the action that makes the contract onerous (for example, has exercised its option to terminate the contract or has ceased using the leased asset), the entity has the discretion to change its intended action.
- 8 Because the Board does not believe that there is a conceptual basis for differentiating onerous contracts that arise within a restructuring plan from those that arise outside such a plan, the Board concluded that it should make a limited amendment to the requirements for onerous contracts generally so as to converge with the specific requirements in SFAS 146 relating to contract termination costs.

## Comment analysis

- 9 From the 123 comment letters received, 83 specifically commented on the question relating to onerous contracts.

	Agreed	Disagreed	No Comment
<i>Question 8 (a) – Do you agree that a liability for a contract that becomes onerous as a result of the entity’s own actions should be recognised only when the entity has taken that action?</i>	45%	20%	35%
<i>Question 8 (b) – Do you agree with the additional guidance for clarifying the measurement of a liability for an onerous operating lease?</i>	45%	15%	40%

	Yes	No	N/A or no comment (agreed with proposed amendment)
<i>Question 8 (c) – If you do not agree would you be prepared to accept the amendments to achieve convergence?</i>	8%	9%	83%

- 10 The majority of the respondents have agreed with the proposed amendment.

We agree that a liability for a contract that becomes onerous as a result of the entity’s own actions should only be recognised when the actions are taken. In practice, management’s intentions often change until irrevocable actions are taken. [CL74]

11 Even though the majority of respondents agreed with the proposals, some respondents (including preparers, standard setters, users and accountancy firms) raised concerns about aspects of them. These concerns are discussed below under the following headings:

- A. Contracts that became onerous due to factors outside the entity's control
- B. Clarification of the term 'own action'
- C. Perceived inconsistency with constructive obligations
- D. Sublease income
- E. Measurement inconsistency in Exposure Draft

**Concern A: Contracts that become onerous due to factors outside the entity's control**

12 Paragraph 57 in the Exposure Draft notes that a contract that requires an entity to make specific payments regardless of whether it takes delivery of contracted products or services may become onerous if the market price of the products or services decline below the contracted price.

**Respondent comments**

13 A small number of respondents, from various sectors and industries, were concerned that this paragraph implies that a liability should be recognised for an onerous contract merely because the price the entity is committed to pay for the goods, services or rights of use under the contract is higher than the current market price.

We think the standard should make it clear that an operating lease (or any other executory contract) does not become onerous merely because rentals are now above market, especially in view of the take-or-pay contract example in paragraph 57 which seems to suggest otherwise and in view of the fact that a liability would arise had the lease been a contract acquired in a business combination. [CL51]

We do not consider that a fixed price contract necessarily becomes onerous if market prices decline below the fixed price. The entity may well be able to continue to derive benefits from the contract that exceed the associated costs even if, with hindsight, it could have achieved lower costs by not entering into a fixed price arrangement. For example, a company might lease premises that are fully utilised and from which it operates profitably (and expects to be able to continue to do so). We would not regard such a lease as becoming onerous in the event that market rents fall below the contractual rental. [CL54]

## Staff evaluation and recommendation

- 14 The first example in paragraph 57 of the Exposure Draft (the take or pay contract) seems to have been interpreted by some to imply that *any* contract will be onerous if the contract price falls below the market price.
- 15 Onerous contracts are not “actions” in themselves, but rather the consequence of some actions taken by the entity or a change in market conditions. The intention of this example was simply to illustrate how a contract *may* become onerous because of factors outside the entity’s controls (eg changing economic conditions) and to highlight the difference with a scenario in which a contract becomes onerous as a result of the entity’s own actions. For the former scenario the Exposure Draft did not propose any new requirements.
- 16 The staff recommend that the following text be added to clarify paragraph 57 in the Exposure Draft. (*New text is underlined.*)

In some cases, contracts become onerous as a result of events outside the entity’s control. For example, a contract that requires an entity to make specified payments regardless of whether it takes delivery of contracted products or services may become onerous if the market price of the products or services declines below the contracted price and as a consequence the benefits that the entity can derive from the products or services become less than the unavoidable costs under the contract. In other cases, the event that makes the contract onerous is an action of the entity. In such cases, the liability for the onerous contract is not recognised until the entity has taken the action. For example, a contract may become onerous because the entity ceases to use the right conveyed by that contract, but continues to incur costs for its obligations under the contract. Therefore, in this example the entity does not recognise a liability until it ceases using the right conveyed by the contract.

### Question for the Board

Does the Board agree with the proposed redrafting?

#### **Concern B: Clarification of the term ‘own action’**

- 17 Paragraph 55 of the Exposure Draft proposes that liabilities for contracts that become onerous due to an entity’s *own actions* be recognised only when the entity has taken the action.

#### **Respondent comments**

- 18 Most respondents agreed with the proposal. However, many of the respondents who agreed and respondents who disagreed requested clarification on the meaning of the phrase ‘own actions’.

We agree that if a contract becomes onerous only as a result of the entity’s own actions, a liability should only be recognised when that action takes place. However, it is not clear from the standard whether the Board was referring to ‘action’ in the sense of ‘decision’ or in the sense of physical or financial implementation. For example, would the decision to vacate, in a year from now, an office held under an operating lease be the past event or would the entity only recognise a liability once it has actually vacated the office? In example 12 the two ‘actions’ are taking place simultaneously so it is not clear what the Board had in mind. From BC 65 one could conclude that it is the date at which the entity no longer uses the office that is the past event. However, BC 65 also refers to the exercise of a termination option in a lease (not the actual vacation of the office) being a past event that may give rise to the recognition of a liability for an onerous contract. The only phrase where a clear answer is provided is actually in the second sentence of the invitation to comment on question 8. We would suggest that this be clarified in the body of the standard. [CL51]



## Staff evaluation and recommendation

- 19 Neither the text, Basis for Conclusions or examples in the Exposure Draft specifically deals with what is meant with the phrase ‘an entity’s own action’. The staff agree with respondents that the lack of guidance on what is meant with the phrase ‘an entity’s own actions’ may result in inconsistent interpretations and applications.
- 20 If a contract becomes onerous as a result of the entity’s own actions, it becomes onerous only once the actual action has occurred, not when the decision to take that action is made. This is because the action, not the decision to take the action, causes an impairment in the value of the entity’s contractual rights. Until the action has been taken, the decision can be reversed.
- 21 It is clear from question 8 in the Invitation to Comment that, in the example of a property under an operating lease that will become vacant as a result of a restructuring, the liability for the unavoidable lease commitment should be recognised only when the entity actually *vacates* the property.
- 22 The staff agree that Board should clarify what is meant by ‘own action’. The staff suggest that additional guidance could be included by adjusting example 12 in the Illustrative Examples accompanying the Exposure Draft. This should result in a better understanding of the intended meaning of the term ‘own action’. We therefore propose the following amendments to example 12 in the Exposure Draft.
- 23 **Example 12: Onerous Contracts**  
(*New text is underlined and deleted text is struck through.*)

An entity operates profitably from a factory it leases under an operating lease. During December 20x0 management decides to ~~the entity~~ relocates the entity’s ~~its~~ operations to a new factory and communicates this decision to the lessor. In February 20x1 the relocation takes place. The lease on the old factory continues for the next four years and it cannot be cancelled. Since the lease started, lease rates on commercial buildings in the entity’s location have declined.

**Recognition of the onerous contract Present Obligation as a result of a past event** – The lease contract for the old factory gave rise to a legal obligation. The contract becomes onerous because the entity does not expect to receive economic benefit from the factory and the contract gives rise to unavoidable costs (ie the remaining lease rentals reduced by the estimated sublease rentals that could reasonably be obtained for the factory). ~~The past event makes this lease contract onerous is the entity vacating the old factory.~~ The lease contract becomes onerous as a result of the entity’s own actions, ie relocation to a new factory.

**Conclusion** – A liability is recognised when the entity relocates to a new factory in February 20x1.

**A note about measurement** – Measurement of the liability is by reference to the unavoidable lease payment reduced by the estimated sublease rentals that the entity could reasonably obtain, even if the entity does not intend to enter into a sublease.

- 24 The staff also recommends amending paragraph 65 in the Basis for Conclusions in the Exposure Draft as follows: *(Deleted text is struck through.)*

The Board noted that onerous contracts can be divided into two broad categories: those that become onerous because of factors outside the entity’s control (for example, a take-or-pay contract in which the market price of the contracted product declines below the contracted price for that product) and those that become onerous because of the entity’s own actions (for example, as a result of vacating a property). Therefore, the Board decided to adopt the recognition requirements of SFAS 146 by specifying that if a contract will become onerous as a result of the entity’s own actions, the liability should not be recognised until the entity has taken that action. The Board believes that until the entity has undertaken the action that makes the contract onerous (for example, ~~has exercised its option to terminate the contract or has~~ ceased using the leased asset), the entity has the discretion to change its intended action.

**Question for the Board**

Does the Board agree with the proposed redrafting?

**Concern C: Perceived inconsistency with constructive obligations**

25 Paragraph 15 of the Exposure Draft proposes the following guidance for constructive obligations:

In the absence of legal enforceability, particular care is required in determining whether an entity has a present obligation that it has little, if any, discretion to avoid settling.

In the case of a constructive obligation this will be the case only if:

- a.) the entity has indicated to other parties that it will accept particular responsibilities
- b.) the other parties can reasonably expect to the entity to perform those responsibilities
- c.) the other parties will either benefit from the entity's performance or suffer harm from its non-performance.

26 Paragraph 55 of the Exposure Draft proposes that liabilities for contracts that become onerous due to an entity's own actions be recognised only when the entity has taken the action.

**Respondent comments**

27 A small number of preparers and standard setters suggested that there was an inconsistency between the requirements for onerous contracts and the recognition guidance for constructive obligations.

The AASB is concerned that the proposed general guidance in respect of the existence of constructive obligations (the Exposure Draft paragraph 15) may not always be consistent with the specific guidance on onerous contracts. As a constructive obligation, it is conceivable that a liability for an onerous contract may be recognised prior to the entity taking any action. This would occur where an entity has made a sufficiently specific current statement to other parties that it will accept particular responsibilities and where the entity has created a valid expectation in those parties that they can reasonably rely on it to discharge those responsibilities. [CL109]

## **Staff evaluation and recommendation**

- 28 The staff does not agree that onerous contracts give rise to constructive obligations or that the requirements for onerous contracts should be based on the requirements for constructive obligations.
- 29 As explained earlier in the paper, a liability to pay lease rentals arises at the start of the lease. The lease becomes onerous only if the (unrecognised) asset becomes impaired. If this impairment occurs as a result of vacating the premises, it occurs when the entity actually vacates the leased premises, not when it announces its plan to do so.
- 30 The staff concluded that there is no inconsistency and that the reason is already explained in the Basis for Conclusions. Therefore the staff recommend that no action is required.

### **Question for the Board**

Does the Board agree?

## **Concern D: Sublease income**

- 31 Paragraph 58 of the Exposure Draft carried forward the guidance from the existing IAS 37 that the unavoidable costs under a contract should reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. However, the Exposure Draft also proposed that if the contract is an operating lease, the entity determines the unavoidable cost by reference to the remaining lease rentals payable, reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease.

- 32 SFAS 146 states that, if an entity ceases to use the right conveyed by an operating lease but does not terminate the lease, the measurement of the resulting liability is based on the remaining lease rentals, reduced by the estimated sublease rentals that could be reasonably obtained for the property, regardless of whether the entity intends to enter into a sublease. The Board decided that it should provide the same guidance on this point in IAS 37 because it was informed that in practice there is uncertainty surrounding the treatment of sublease income.

### **Respondent comments**

- 33 Most respondents agreed with or made no comment on the proposed amendment. However, most of the *preparers* who commented did not agree with this proposal. They argue that the measurement should be entity specific and therefore, if appropriate, reflect that the entity does not intend to sublease.

The provision should only be reduced when action has been taken to find a sublease. If no action has been taken then the onerous contract should not be reduced by sublease income and if the action is taken subsequently, the provision should be re-measured. Moreover it is not reliable to assume that a building might be subleased if the situation of the market is that subleases cannot be found. [CL104]

- 34 Some respondents require clarification on whether sublease rentals should be deducted when the lease contract does not permit a sublease to take place.

We do not agree with the reduction of the liability by the estimated lease sub rentals regardless of whether the entity intends to enter into a sublease. For example, we believe that when the lease contract prevents the lessee from entering into sublease contracts, the remaining lease commitment of the onerous contract should not be reduced by estimated sublease rentals. [CL60]

### **Staff evaluation and recommendation**

- 35 There are two distinct concerns expressed by respondents

*a. The entity may not intend to sublet*

- 36 A few respondents, predominantly preparers, suggested that entities should deduct sublease rentals only if they intend to sublet the property. However, as was argued in paragraph BC67 of the Basis for Conclusions accompanying the

Exposure Draft, it can be argued that such an approach would be inconsistent with the proposed measurement requirements.

- 37 The objective of the proposed measurement requirements is to measure liabilities at the amount that the entity ‘would rationally pay to settle the present obligation or to transfer it to a third party’ at the measurement date. If an entity is leasing vacant property under a non-cancellable lease, the entity has to consider how much a third party would demand to assume the lease. A third party would rationally take into account the income that it could generate from the lease, ie the sublease rentals that it could reasonably obtain by subletting the property.
- 38 Consistent with the general measurement objective, the specific requirement for onerous contracts is to measure the ‘least net cost’. The requirement to take into account sublease rentals when measuring the liability for an onerous lease of vacant property is an application of this specific requirement.

***b. Subletting might not be feasible or permitted***

- 39 Some respondents argued that it is inappropriate to require sublease rentals to be taken into account if subletting is prohibited under the terms of the lease or if the market is such that the entity is unlikely to find a sublessee.
- 40 It could be argued that these situations are already adequately addressed in the proposed requirements. The Exposure Draft proposes that entities should deduct sublease rentals that ‘*could be reasonably obtained*’. If subletting is prohibited, no sublease rentals can reasonably be obtained, so none would be taken into account in the measurement of the liability. Similarly, if there is little demand for leased property, the entity could assume that the sublease rentals that it could reasonably obtain would be relatively low in value. Indeed the reason that the entity is not subletting might be that the rentals would be little more than the costs of securing the sublease. So only a small amount (if any at all) would need to be taken into account in the measurement of the liability.

- 41 On the basis of the above arguments, the staff conclude that the proposed convergence amendments for sublease income are consistent with the proposed measurement objectives for IAS 37, are adequately explained in paragraph BC67 of the Basis for Conclusions and adequately address situations in which sublease rentals cannot be obtained in practice. The staff also note that, overall, few respondents objected to the proposals. Therefore the staff recommend no changes.

#### **4.4 Question for the Board**

Does the Board agree?

### **Concern E: Measurement inconsistency in the Exposure Draft**

#### **Respondent comments**

- 42 A few respondents noted that the text in paragraphs 55 and 58 of the Exposure Draft appear to be conflicting in their measurement requirements for an onerous contract. These respondents noted that paragraph 55 states an entity ‘shall recognise as a liability the present obligation under the contract’. This indicates that the liability is the *gross* present obligation. However, paragraph 58 requires an entity to deduct expected future economic benefits from the unavoidable cost of meeting the obligation, which indicates a *net* obligation is recognised.

#### **Staff evaluation and recommendation**

- 43 The staff agree that the two paragraphs might be interpreted to be conflicting. The staff suggest that paragraph 55 in the Exposure Draft should be amended as follows: (*New text is underlined.*)

If an entity has a contract that is onerous, it shall recognise as a liability the net present obligation under the contract. If the contract will become onerous as a result of the entity’s own actions, the entity shall not recognise the liability until it has taken the action.

- 44 The staff also suggest that paragraph 58 in the Exposure Draft should be amended as follows:

*(New text is underlined and deleted text is struck through.)*

A contract is onerous when the unavoidable costs of meeting its obligations exceed its expected economic benefits. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. If the contract is an operating lease of an asset that the entity no longer uses, the entity determines the net present obligation ~~unavoidable cost~~ by reference to the remaining lease rentals payable, reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease.

**5.4 Question for the Board**

Does the Board agree with the proposed redrafting?