IASB Meeting Agenda reference **11A**

Staff Paper Date **November 2009**

Project **Liabilities—amendments to IAS 37**

Topic **Measurement guidance—onerous contracts**

Paper overview

1. The Board has decided tentatively to clarify that entities should measure liabilities in the scope of IAS 37 by reference to the value, rather than the cost, of the outflows required to fulfil the obligation. Applying this proposal, the measurement attribute of the outflows used to *measure* an onerous contract (value) would be different from that used to identify the contract as onerous in the first place (cost).

2. This paper considers whether, and if so how, the Board should remove the difference. It considers three options:

   Option 1: eliminate the difference by changing the definition of an onerous contract.

   Option 2: eliminate the difference by changing the measurement requirements for onerous sales contracts, ie by creating an exception from the general measurement requirements in IAS 37.

   Option 3: accept and acknowledge the difference.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

3. The paper recommends that the Board:

   (a) adopt Option 2 on a temporary and limited basis, ie creating a temporary limited measurement exception in IAS 37 for onerous contracts arising from transactions within the scope of IAS 18 *Revenue* or IFRS 4 *Insurance Contracts*.

   (b) emphasise in literature accompanying the revised proposals that:

      (i) the purpose of the exception is to postpone any change in practice for measuring those contracts, pending completion of the revenue and insurance projects; and

      (ii) when the Board issues new revenue and insurance standards, it will either confirm the exception (possibly taking the contracts out of the scope of IAS 37) or delete it (bringing the measurement requirements for onerous sales and/or insurance contracts into line with the measurement of other liabilities in the scope of IAS 37).

4. The rest of this paper explains the reasons for this recommendation. It:

   (a) summarises existing IAS 37 requirements for onerous contracts (paragraphs 5-8);

   (b) identifies the scope of the issue that arises from the proposed changes to the measurement guidance (paragraphs 9-13); and

   (c) sets out more fully the three options for resolving the issue and the pros and cons of each option (paragraphs 14-22).

Existing requirements / exposure draft proposals for onerous contracts

5. ‘Onerous contracts’ are within the scope of IAS 37[1], unless they are specifically addressed by another standard[2].

6. IAS 37 states that:

> An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.[3]

> …The unavoidable costs under the 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.[4]

> If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.[5]

7. The onerous contract requirements in IAS 37 apply at two different stages in a contract:

    (a) they apply while any contract is ‘executory’, ie while neither party has performed its obligations or both parties have partially performed to an equal extent.[6]

    > An example of an executory contract is one in which the entity leases property under an operating lease. The contract is onerous if the future lease rentals exceed the economic benefits the entity expects to derive from the property.

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[1] IAS 37, paragraph 1.
[2] Most notably, onerous construction contracts are addressed in IAS 11 *Construction Contracts*.
[3] IAS 37, paragraph 10
[4] IAS 37, paragraph 68
[5] IAS 37, paragraph 66.
[6] IAS 37, paragraph 3.

(b) the IAS 37 onerous contract requirements also apply to sales contracts if the customer has paid for goods or services but the entity has not yet delivered them. They apply if the liability (measured as deferred revenue) that the entity recognises applying IAS 18 *Revenue* (or, in some circumstances[7], IFRS 4 *Insurance Contracts*) is less than the unavoidable costs of meeting the obligations. As made explicit in IFRIC 13 *Customer Loyalty Programmes*, the IAS 37 requirements apply as a form of 'liability adequacy' test.

> If at any time the unavoidable costs of meeting the obligations to supply the awards are expected to exceed the consideration received and receivable for them (ie the consideration allocated to the award credits at the time of the initial sale that has not yet been recognised as revenue plus any further consideration receivable when the customer redeems the award credits), the entity has onerous contracts. A liability shall be recognised for the excess in accordance with IAS 37. The need to recognise such a liability could arise if the expected costs of supplying awards increase, for example if the entity revises its expectations about the number of award credits that will be redeemed.[8]

8. The exposure draft of proposed amendments to IAS 37 did not propose any significant changes to the existing requirements. Thus the existing—and proposed—trigger for *identifying* an onerous contract is one in which the obligation leg of the contract is measured at cost. This is consistent with existing practice for *measuring* the onerous contract—practice widely interprets IAS 37 as requiring obligations (and hence the obligation leg of an onerous contract) to be measured at cost.

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[7] IFRS 4 requires insurers to use IAS 37 as the basis for a liability adequacy test if they do not apply their own form of liability adequacy test that meets specified minimum requirements. IFRS 4, paragraphs 15-19.

[8] IFRIC 13 *Customer Loyalty Programmes, paragraph 9.*

The issue the Board has to address

9. The Board has decided tentatively to clarify that entities should measure liabilities by reference to the value, rather than the cost, of the resource outflows. Applying this proposal, the measurement attribute used to measure the outflows in an onerous contract (value) would be different from that used to trigger recognition (cost).

10. Typically, the difference would have practical implications only for contracts that oblige the entity to supply goods or services. This is because the proposed changes in the measurement requirements will affect only obligations to undertake services—they will not affect obligations to make cash payments.

> If an entity enters a contract to *sell* goods or services, its obligation under the contract is to deliver goods or services. The unavoidable future costs used to determine whether the contract is onerous (and hence trigger recognition) are the unavoidable *costs* of supplying the goods or services. Applying the proposed measurement requirements, the outflows used to measure the obligation would be the *value* of the goods or services.
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> In contrast, if an entity enters a contract to *purchase* goods or services, its obligation under the contract is typically to pay cash to the counterparty. The unavoidable future costs used to identify whether the contract is onerous are the cash payments. The future outflows used to measure the liability are also the cash payments.

11. Because the difference affects only obligations arising from contracts to supply goods or services, it might not be a long-term issue for IAS 37: in future, obligations arising from contracts with customers—including onerous contract obligations— could be in the scope of new standards that replace IAS 18 *Revenue,* IAS 11 *Construction Contracts* and IFRS 4 *Insurance Contracts*.[9]

12. However, until that time, onerous contracts with customers (other than those in the scope of IAS 11) will be within the scope of IAS 37. Further, it is possible that they will remain so thereafter. In the discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers* ('the revenue discussion paper'), the IASB and FASB ('the boards') proposed an 'allocated transaction approach' for revenue recognition, with no remeasurement of performance obligations unless the contract is onerous.[10] Some respondents have suggested that, applying such an approach, the new revenue standard, like IAS 18, should require entities to apply IAS 37 to identify, recognise and measure onerous sales contracts.

13. Thus onerous sales and insurance contracts remain, either temporarily or permanently, within the scope of IAS 37. Therefore, the Board needs to consider in this project whether and, if so, how it should eliminate the difference between the recognition trigger and measurement requirements for those contracts.

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[9] This analysis assumes that the only onerous contracts to supply goods or services that are within the scope of IAS 37 are sales contracts within the scope of IAS 18 and IFRS 4. Other contracts to supply goods or services (eg contracts to sell or lease property, plant or equipment) would typically relate to assets already owned by the entity. If such contracts became onerous, the entity would recognise an impairment loss on the asset, not an onerous contract liability.

[10] Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*, December 2008, paragraphs 5.55-5.101.

Options for the Board

14. The staff have identified three ways in which the Board could address this issue:

    Option 1: eliminate the difference by changing the definition of an onerous contract.

    Option 2: eliminate the difference by changing the measurement requirements for onerous sales contracts, ie by creating an exception from the general measurement requirements in IAS 37.

    Option 3: accept and acknowledge the difference.

Option 1—Change the definition of an onerous contract

15. The first option is to amend the definition of an onerous contract to make it consistent with the proposed measurement requirements.

16. The exposure draft definition could be changed to something like:

    > A contract is **onerous** when ~~the unavoidable costs of meeting~~ its obligations exceed its expected economic benefits.

    Additional guidance could clarify that the ‘obligations’ referred to in the definition should be measured in accordance with the measurement requirements of the revised standard, ie based on the value, rather than cost, of the goods or services to be delivered.

17. An advantage of this approach is that it eliminates the difference between the recognition trigger and measurement requirements for onerous sales contracts, without creating any new inconsistencies.

18. However, the approach would make entities recognise onerous contracts more often. Sales contracts could become onerous as soon as they became 'off-market', even if they remain profitable. As the boards noted in the revenue discussion paper[11], the result would closely resemble a revenue recognition approach in which entities remeasure performance obligations at each financial statement date. The boards concluded that such an approach would be unnecessarily complex for most contracts with customers. Thus, the discussion paper proposed to retain the present cost-based trigger[12]. Applying this trigger, the contract margin would act as a recognition hurdle: only if the adverse changes exceeded this hurdle would an entity have to remeasure its performance obligations.

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[11] Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*, December 2008, paragraph 5.72.

[12] Ibid., paragraph 5.82.

Option 2—Change the measurement requirements for onerous contracts

19. A second option would be to use cost as both the recognition trigger and the measurement attribute for onerous sales contracts in the scope of IAS 37. This could be achieved by creating a limited exception to the general measurement requirements in IAS 37. The exception could be limited to transactions within the scope of IAS 18 *Revenue* or IFRS 4 *Insurance Contracts*.[13] It could require entities to apply the measurement requirements of IAS 37, *except* the requirement to measure future outflows of goods and services on the basis of their value.

20. In support of this option it could be argued that:

    (a) it maintains consistent measurement attributes for recognising and measuring onerous contracts. The boards have recently used this argument to support their conclusions in the revenue discussion paper:

    > The boards' view is that once a performance obligation is deemed onerous, it should be remeasured on a basis that is consistent with the trigger.[14]

    (b) entities do not earn any profit from contracts identified as onerous, ie they sell the goods and services at a loss. Including a margin in the liability would lead entities to recognise a larger loss in one period, and a profit in the later period when they transfer the goods or services. The recognition of a profit in the later period is not a faithful representation of the entity's performance in an onerous contract.

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[13] Onerous construction contracts are outside the scope of IAS 37. IAS 11 *Construction Contracts* already requires entities to measure an onerous construction contract by reference to the expected costs of fulfilling the contract.

[14] Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*, December 2008, paragraph 5.73.

Option 3—Accept and acknowledge the difference

21. The third option is to accept that the recognition trigger used to identify onerous sales contracts (cost) is different from the attribute used to measure them (value). To avoid any misunderstandings, the standard could explicitly acknowledge the difference, and perhaps illustrate its effect.

22. In favour of this option, it could be argued that:

    (a) it is more important that onerous contracts are measured consistently with other liabilities than that the recognition trigger for onerous contracts is consistent with the measurement requirements. There is a practical reason for introducing a cost-based recognition hurdle for onerous contracts—as noted in paragraph 18, it avoids imposing requirements that are unnecessarily complex for most sales contracts. However, there is no practical reason for applying cost-based measurement requirements for onerous sales contracts—it would be no more difficult (and possibly often easier) to apply the proposed IAS 37 measurement requirements to onerous sales contracts than to apply them to other service obligations.

    (b) including a margin in the measurement of onerous sales contracts ensures a faithful representation of the changes in expectations that have caused the contract to become onerous. The statement of performance recognises increases in expected costs in full in the period in which expectations change. (If entities instead measure liabilities at cost, the statement of performance reflects only changes in excess of the original expected margin.)

Staff conclusions and recommendations

23. For the reasons in paragraph 22, the IAS 37 project staff prefer Option 3, ie accepting and acknowledging the difference between the recognition trigger and proposed measurement requirements for onerous contracts. So, if the Board were undertaking the IAS 37 project in isolation, we would recommend Option 3.

24. However, the boards have already considered onerous sales contracts in the revenue project. They have proposed that a new revenue standard should use cost as the basis for both recognising and measuring onerous sales contracts, ie preserving existing practice. They might take a similar view in the insurance project. The staff think that the Board should not require any changes of practice now, if it might reverse those changes when it issues new revenue and insurance standards. To avoid this risk, the staff recommend that the Board include a temporary exception from the measurement requirements in IAS 37, pending completion of the revenue and insurance projects—ie adopt Option 2 as a temporary measure.

25. The Board might not retain the proposals in the revenue discussion paper. It might instead take up the suggestion of some respondents that onerous contracts should remain within the scope of IAS 37. If the Board decided to take up this suggestion, it could reverse the temporary exception in IAS 37 when it issues the new revenue and/or insurance standards.

26. However, having granted an exception, the Board might encounter opposition to its deletion. And the Board would have to be careful to avoid an impression that, by adding and then reversing an exception, it has required two changes in practice (when in fact there has only been one). To minimise these risks, the Board could emphasise the purpose of the exception, and its temporary nature.

Question for the Board

Question: Onerous sales contracts
The staff recommend: (a) that the Board creates a limited exception to the proposed measurement requirements in the revised IAS 37. The exception should be restricted to onerous contracts arising from transactions within the scope of IAS 18 *Revenue* and IFRS 4 *Insurance Contracts*. It should allow entities to measure their contractual obligations to provide goods or services on the basis of the expected cost, rather than the value, of the goods or services; and (b) that the Board emphasises in literature accompanying the revised proposals that: (i) the purpose of the exception is to postpone any change in practice for measuring those contracts, pending completion of the revenue and insurance projects; and (ii) when the Board issues its new revenue and insurance standards, it will either confirm the exception (possibly taking the contracts out of the scope of IAS 37) or delete it (bringing the measurement requirements for onerous sales and/or insurance contracts into line with the measurement of other liabilities in the scope of IAS 37). Do you agree?