STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**Costs considered in assessing whether a contract is onerous (IAS 37)**
Paper topic	Items on the current agenda

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Introduction

1. In November 2017, the IFRS Interpretations Committee (Committee) decided to add a narrow-scope standard-setting project to its agenda. The objective of the project is to clarify the meaning of the term 'unavoidable costs' in the definition of an onerous contract in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In March 2018, the Committee discussed what requirements to propose and the form of the standard-setting activity.

2. The objective of this paper is to consider:

   (a) whether to propose any specific disclosure requirements; and

   (b) transition for the proposed amendments to IAS 37.

3. The paper includes:

   (a) a summary of staff recommendations (paragraph 5);

   (b) background information (paragraphs 6–11); and

   (c) staff analyses, conclusions and recommendations on:

      (i) disclosure (paragraphs 12–16); and

      (ii) transition (paragraphs 17–36).

4. Following this Committee meeting, we plan to bring a paper to the Board that outlines all of the Committee's recommendations on this project.

Summary of staff recommendations

5. The staff recommend that the Board propose:

   (a) no additional disclosure requirements;

   (b) that entities already reporting using IFRS Standards apply a 'modified retrospective' approach, ie entities would apply the proposed amendments to contracts existing at the date of initial application (the beginning of the annual reporting period in which the entity first applies the amendments); and

   (c) no specific transition requirements for first-time adopters.

Background information

Request

6. The Committee received a request asking which costs an entity considers when assessing whether to recognise an onerous contract provision applying paragraph 68 of 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 are within the scope of IFRS 15 *Revenue from Contracts with Customers*.

Requirements in IFRS Standards

7. IAS 11 specified which costs an entity includes (and excludes) in assessing whether a contract to which it applied IAS 11 is onerous. IFRS 15 does not include similar requirements. 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, when determining which costs to include

in assessing whether a contract is onerous, an entity applies the definition of an onerous contract in IAS 37—it does not apply the previous requirements in IAS 11 or the requirements in IFRS 15 on costs that relate directly to a contract.

8. 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 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, IAS 37 does not specify which costs an entity includes in determining the cost of fulfilling a contract.

Previous Committee discussions

November 2017

9. In November 2017, the Committee considered the feasibility and scope of possible narrow-scope standard-setting to address the question raised in the request. The Committee decided to add a standard-setting project to its agenda to clarify the meaning of the term ‘unavoidable costs’ in the IAS 37 definition of an onerous contract.

10. The Committee also reached tentative 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 project should aim to clarify only the requirements for identifying onerous contracts, and not address measurement.

    (c) the project should aim to clarify only the term ‘unavoidable costs’ in the IAS 37 definition of an onerous contract, and not address other aspects of the definition such as the meaning of the phrase ‘economic benefits expected to be received’.

March 2018

11. In March 2018, the Committee recommended that the Board should:

(a) specify that the 'cost of fulfilling' a contract comprises the 'costs that relate directly to the contract';

(b) provide examples of costs that do (and do not) relate directly to a contract to provide goods or services; and

(c) develop its proposals as a narrow-scope amendment to IAS 37, rather than as an Interpretation of IAS 37 or as part of the annual improvements process.

Disclosure requirements

Introduction

12. At the Committee's March 2018 meeting, one Committee member asked whether the Board should propose specific disclosure requirements as part of its project to amend IAS 37.

Staff analysis

13. Paragraphs 84 and 85 of IAS 37 contain disclosure requirements for provisions, including those arising from onerous contracts:

> 84 For each class of provision, an entity shall disclose:
>
> (a) the carrying amount at the beginning and end of the period;
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> (b) additional provisions made in the period, including increases to existing provisions;
>
> (c) amounts used (ie incurred and charged against the provision) during the period;
>
> (d) unused amounts reversed during the period; and

> (e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.
>
> Comparative information is not required.
>
> 85 An entity shall disclose the following for each class of provision:
>
> (a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
>
> (b) an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events, as addressed in paragraph 48; and
>
> (c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

14. We think additional disclosure requirements are not necessary. This is because:

    (a) the proposed amendments are narrow in scope. They would not change the underlying principle or general requirements for onerous contracts; rather, the proposed amendments are intended to clarify 'the cost of fulfilling' a contract when applying the onerous contract requirements in IAS 37. The proposed amendments would not therefore create additional judgements that would necessitate additional disclosure requirements.

    (b) onerous contracts previously within the scope of IAS 11 will now be within the scope of IAS 37. IAS 11 did not contain disclosure requirements specifically for onerous contracts and, accordingly, applying the requirements in IAS 37 does not result in any loss of information for users of financial statements. We also reviewed the *IFRS Taxonomy* to identify if entities commonly disclose additional information about onerous contracts. We did not identify any such disclosures.

(c) determining the cost of fulfilling a contract could, in some cases, require the use of estimates. However, this is not a new requirement that would result from the proposed amendment. In addition, we note that paragraph 85(b) of IAS 37 (reproduced above in paragraph 13 of this paper) and paragraph 125[1] of IAS 1 *Presentation of Financial Statements* already requires an entity to disclose particular information about uncertainties.

15. We also think it is beyond the scope of this narrow-scope project to consider the usefulness of the existing disclosure requirements in IAS 37 for provisions. Accordingly, we have not performed such an analysis.

Staff conclusion and recommendation

16. Based on our analysis, we think the proposed amendments to IAS 37 do not create the need for additional disclosure requirements. Accordingly, we recommend that the Board propose no new disclosure requirements as part of these narrow-scope amendments.

Question 1 for the Committee
Does the Committee agree with our recommendation to propose no new disclosure requirements?

[1] Paragraph 125 of IAS 1 states: 'An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of: (a) their nature, and (b) their carrying amount as at the end of the reporting period.'

Transition requirements

Entities already reporting using IFRS Standards

Introduction

17. The proposed amendments to IAS 37 could result in some entities changing which costs they consider in assessing whether a contract is onerous. This could result in these entities including either fewer costs or additional costs in the assessment.

18. We first considered whether an entity could transition to the proposed amendments applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors,* rather than by applying transition requirements developed specifically for the amendments.

Retrospective application applying IAS 8

19. Paragraph 22 of IAS 8 specifies that retrospective application requires an entity to adjust the opening balance of each affected component of equity for the earliest prior period presented, and the other comparative amounts disclosed for each prior period presented, as if the new accounting policy had always been applied.

20. In practice, retrospective application of these proposed amendments would require an entity to apply the amended requirements to contracts existing at the start of its earliest comparative period to determine whether those contracts are onerous at that date. The entity would not be required to consider contracts completed before the start of the earliest comparative period.

21. In our view, an entity that, as a result of the amendments, would include fewer costs in assessing whether a contract is onerous would generally have the information needed to do so. This is because the entity would simply be removing costs that it had already included in its assessment.

22. However an entity that, as a result of the amendments, would include additional costs may be required to obtain information about particular costs that it had not previously captured. Although an entity would not be required to do this for prior periods if doing so would be impracticable, we think there could be some situations in which it

might be difficult (and costly) to obtain the information needed at the start of the earliest prior period presented, but not impracticable to do so (as defined by IAS 8[2]).

23. Onerous contracts are often non-recurring in nature and, thus, we think that retrospective application applying IAS 8 would not generally providers users of financial statements with useful trend information. Users may obtain some useful information if retrospective application were to highlight a particular point in the fulfilment of contracts that repeatedly causes an entity's contracts to become onerous—however, we do not expect this to be common.

24. Accordingly, we do not recommend proposing that entities be required to transition to the proposed amendments applying IAS 8. We therefore considered two other approaches for how an entity could transition to the proposed amendments:

    (a) Prospective application as defined in IAS 8; and

    (b) Modified retrospective application—ie an entity would apply the proposed amendments to contracts existing at the date of initial application.

Prospective application as defined in IAS 8

25. Paragraph 5 of IAS 8 defines prospective application of a change in accounting as 'applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed...'.

26. In practice, prospective application of these proposed amendments would require an entity to apply the amended requirements only to contracts entered into on or after the effective date. Entities would continue to apply the previous requirements to contracts existing at the effective date. This could result in an entity applying two different assessments for contracts entered into before and after the effective date of the amendments, which could last for some considerable time if the entity has long-term contracts. In our view, this would be confusing for users of financial statements and, therefore, we do not recommend this approach.

[2] The definition of impracticable in IAS 8 states that 'applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so'.

Modified retrospective application

27. Applying this approach, an entity would apply the proposed amendments to contracts existing at the date of initial application (ie the start of the annual reporting period in which the entity first applies the amendments). Entities would not restate comparative information, and instead would recognise the cumulative effect of initially applying the amendments in retained earnings (or another component of equity, as appropriate) at the date of initial application.

28. This approach is similar to the transition approach permitted by some IFRS Standards, such as IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers*, IFRS 16 *Leases* and IFRIC 23 *Uncertainty over Income Tax Treatments*.

29. We think the modified retrospective approach avoids the drawbacks of retrospective application applying IAS 8 (see paragraphs 22–23 above) and prospective application (see paragraph 26 above). In our view, the modified retrospective approach would appropriately balance costs incurred by an entity in applying the proposed amendments with the usefulness of information provided to users of financial statements.

30. Accordingly, we recommend proposing that entities would apply the modified retrospective approach when first applying the amendments.

31. We also considered whether the Board should provide an option to apply the amendments retrospectively (as discussed in paragraphs 19–23 of this paper). We think the benefits of that approach would be limited and are outweighed by the disproportionate complexity and possible loss of comparability across entities that such an option would introduce. Accordingly, we recommend not providing entities with this option.

First-time adopters

32. Paragraph BC27 of IFRS 1 *First-time Adoption of International Financial Reporting Standards* states:

> The Board expects that most first-time adopters will begin planning on a timely basis for the transition to IFRSs. Accordingly, in balancing benefits and costs, the Board took as

its benchmark an entity that plans the transition well in advance and can collect most information needed for its opening IFRS balance sheet at, or very soon after, the date of transition to IFRSs.

33. Accordingly, we think a first-time adopter would be able to apply the proposed amendments at its date of transition to IFRS Standards, and would not need specific relief to do so.

34. In addition, IFRS 1 does not provide any exception or exemption from the requirements of IAS 37 for onerous contracts. We do not see any particular benefit to providing first-time adopters with an exemption relating to one aspect of assessing whether a contract is onerous.

35. Accordingly, we recommend no specific transition requirements for first-time adopters.

Staff recommendation

36. Based on our analysis, we recommend that the Board propose:

(a) that entities already reporting using IFRS Standards apply the proposed amendments to IAS 37 to contracts existing at the date of initial application (ie the beginning of the annual reporting period in which the entity first applies the amendments); and

(b) no specific transition requirements for first-time adopters.

Question 2 for the Committee
Does the Committee agree with our recommendation to propose: (a) that entities already reporting using IFRS Standards apply the proposed amendments to IAS 37 only to contracts existing at the date of initial application (ie the beginning of the annual reporting period in which the entity first applies the amendments); and (b) no specific transition requirements for first-time adopters.