

## STAFF PAPER

October 2019

## IASB® Meeting

<b>Project</b>	<b>Onerous Contracts—Cost of Fulfilling a Contract (Proposed amendments to IAS 37)</b>		
<b>Paper topic</b>	Other comments		
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### Introduction and purpose

1. This paper analyses comments on matters other than those on which the Board specifically invited comments in [Exposure Draft \*Onerous Contracts—Cost of Fulfilling a Contract\*](#) (Exposure Draft).
2. This paper discusses comments on:
  - (a) the scope of the project (paragraphs 4–15);
  - (b) the interaction with impairment requirements (paragraphs 16–27); and
  - (c) the transition requirements (paragraphs 28–44).
3. This paper also includes an appendix, analysing other comments made by respondents.

### Scope of the Project

#### *Feedback overview*

4. The Exposure Draft proposed to make a narrow-scope amendment to IAS 37 to clarify which costs an entity includes in determining the ‘cost of fulfilling’ a contract for the purpose of assessing whether that contract is onerous. Some respondents suggested that the Board also consider other aspects of the onerous contract requirements. They suggested that the Board clarify:
  - (a) what is meant by the term ‘economic benefits’ (paragraphs 5–8);

- (b) how an entity measures an onerous contract provision (paragraphs 9–10); and
- (c) combining or segmenting contracts (paragraph 11).

*Economic benefits*

5. 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’.
6. Some respondents (mostly national standard-setters and accountancy bodies but also a few accounting firms and groups representing preparers of financial statements) said it would not be beneficial to consider the cost of fulfilling a contract without also considering the meaning of economic benefits within the definition of an onerous contract.
7. Respondents requested clarification of four aspects of the meaning of economic benefits:
  - (a) most respondents who commented on this topic asked the Board to clarify whether the term economic benefits refers only to contract revenue or also includes wider benefits, such as access to new markets and/or contracts, maintaining good customer relationships or maintaining employee’s technical skills and experience.
  - (b) some respondents asked how an entity measures any variable consideration to which it is entitled.
  - (c) one national standard-setter asked how to determine economic benefits when a contract does not generate cash inflows largely independent of other assets of the entity.
  - (d) another national standard-setter asked whether economic benefits are considered to be nil when an entity determines the unavoidable cost of a contract to be the compensation or penalties arising from failure to fulfil it.
8. A group representing preparers of financial statements agreed with the Board’s decision not to address economic benefits as part of this project. A few respondents

suggested that the Board consider economic benefits as part of its research project on Provisions.

*Measurement*

9. Several respondents suggested clarifying whether an entity is required to measure an onerous contract provision using the same costs as it used to identify the contract as onerous (noting that paragraph BC14 of the Exposure Draft said an entity could measure it using the same costs).
10. An accounting firm asked for clarity as to whether and how the Board’s proposals would affect the measurement of liabilities within the scope of IAS 37 that are not onerous contracts.

*Combining or segmenting contracts*

11. Some respondents (including national standard-setters, accounting firms and a preparer of financial statements) suggested clarifying whether and when an entity combines or segments separate legal contracts when applying the onerous contract requirements in IAS 37. Those respondents noted that IFRS 15 includes requirements for combining contracts and asked whether IAS 37 would apply to a combined contract as defined by IFRS 15 or to each contract that is legally separate.

**Staff analysis and recommendation**

12. In developing the Exposure Draft, the Board considered whether to expand the scope of the project to clarify the meaning of ‘economic benefits’ within the definition of an onerous contract. Paragraph BC15 of the Exposure Draft acknowledged that questions sometimes arise on this matter. However, it also explained that the Board decided not to address the matter as part of the proposed amendments because (a) it is not a question prompted by the withdrawal of IAS 11 *Construction Contracts* (as was the case for the cost of fulfilling a contract); and (b) expanding the scope of the project could cause delay.
13. The Board also considered whether to expand the scope of the project to clarify how an entity should measure an onerous contract provision. In paragraphs BC12–

BC14 of the Exposure Draft, the Board explained why it decided not to do so.

Those paragraphs explained that:

- (a) expanding the scope of the project could cause delay; and
- (b) the measurement requirements for onerous contract provisions may not need clarification—an entity could measure an onerous contract provision by including the same costs as it used to identify the contract as onerous.

14. We note that:

- (a) most respondents either did not comment on the project scope or agreed with the Board’s reasoning in paragraphs BC12–BC15;
- (b) those who disagreed did not raise matters beyond those considered by the Board in developing the Exposure Draft;
- (c) the reasoning in paragraphs BC12–BC15 would also apply to other suggestions for expanding the scope of this project, for example the suggestion that the Board clarify whether and when an entity should combine or segment contracts; and
- (d) the Board is due to decide soon whether to initiate a wider-scope project on IAS 37. The Board would have an opportunity within that project to address any matters that are giving rise to significant problems in practice.

15. For the reasons in paragraph 14, we recommend that the Board does not expand the scope of this project to address:

- (a) the meaning of ‘economic benefits’ in the IAS 37 definition of an onerous contract;
- (b) whether and when an entity should combine or segment contracts; or
- (c) how an entity should measure an onerous contract liability.

**Question 1—project scope**

Does the Board agree with the staff recommendation in paragraph 15 of this paper?

**Interaction with impairment requirements****Feedback overview**

16. Paragraph 69 of IAS 37 states:

Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract (see IAS 36).

17. A few respondents (mostly national standard-setters) suggested clarifying whether the requirements in paragraph 69 of IAS 37 apply to assets that are not subject to the impairment requirements in IAS 36 *Impairment of Assets*.

18. A national standard-setter and accounting firm also suggested clarifying what ‘dedicated’ means in the context of assets that are used to fulfil several contracts.

The national standard-setter said:

The allocation of the depreciation of fixed assets that are used for a number of contracts, if their use is necessary to fulfil the contracts, is included in the costs to assess whether a certain contract is onerous under the directly related cost approach. However, if the asset is not dedicated to a specific contract in accordance with paragraph 69 of IAS 37 because the asset is also used for other contracts, we believe the relationship between the impairment losses on an asset that is not dedicated to a specific contract and the provisions for onerous contracts is not clear.

19. The national standard-setter suggested the Board amend paragraph 69 of IAS 37 to replace ‘dedicated’ with ‘that relate directly’.

**Staff Analysis and conclusions**

*Does paragraph 69 of IAS 37 refer to assets not within the scope of IAS 36?*

20. Paragraph 2 of IAS 36 states that IAS 36 applies to impairment of all assets except for nine types of assets. Some of the assets excluded from the scope of IAS 36 could be used by an entity to fulfil a contract. Such assets could include, for example, inventory accounted for applying IAS 2 *Inventories*, financial assets measured at fair value applying IFRS 9 *Financial Instruments* and biological assets measured at fair value applying IAS 41 *Agriculture*.
21. These assets do not need to be assessed for impairment because the basis on which they are measured (whether fair value or lower of cost and net realisable value) already reflects any reduction in the asset's recoverable amount.
22. In addition, the wording of paragraph 69 of IAS 37 could be read to support a view that an entity recognises an impairment loss on any asset dedicated to the contract, even if that asset is subject to impairment requirements applying Standards other than IAS 36. The argument would be that IAS 36 is specifically mentioned in the paragraph because it is the impairment Standard that applies to most asset types.
23. Accordingly, we conclude there is no need to clarify the reference to IAS 36 in paragraph 69 of IAS 37 in this respect.

*What does 'dedicated' mean?*

24. Amending paragraph 69 of IAS 37 to replace 'dedicated' with 'that relate directly' would better align paragraph 69 with the proposals in the Exposure Draft. It would clarify that an entity considers the same assets when applying paragraph 69 of IAS 37 as it does when applying proposed paragraph 68 of IAS 37.
25. This change could cause a change in practice in some instances. For example, the manual of one accounting firm notes that, in that firm's view, an asset is dedicated to a contract only if there is a contractual requirement to use a specified asset or no other asset can be used.
26. However, that opinion was formed applying the existing requirements in IAS 37 rather than the proposed requirements. If entities are required to include all costs that

relate directly to a contract in assessing whether a contract is onerous, it would be logical to also first review for impairment the assets that relate directly to the contract.

27. For the reasons outlined in paragraphs 24–26, we recommend changing paragraph 69 of IAS 37 to be consistent with the wording of the amendments proposed in the Exposure Draft. Accordingly, we recommend the Board amend paragraph 69 of IAS 37 to refer to assets that relate directly to a contract, rather than assets dedicated to a contract. This could look like:

69 Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets ~~dedicated to that~~ that relate directly to the contract (see IAS 36).

**Question 2—interaction with impairment requirements**

Does the Board agree with the staff recommendation to amend paragraph 69 of IAS 37 to refer to assets that relate directly to a contract, rather than assets dedicated to a contract?

**Transition requirements**

***Exposure Draft proposals***

28. The Board proposed to require entities to apply a ‘modified retrospective’ approach on transition—ie apply the amendments to contracts existing at the beginning of the annual reporting period in which the entity first applies the amendments. Entities would not be permitted to restate comparative information.

***Feedback overview***

29. Some respondents commented on the Board’s proposed transition requirements. Views were divided amongst this group:
- (a) some supported the proposals. Those respondents include national standard-setters, regulators, accounting firms and groups representing preparers of financial statements.

- (b) some—mainly national standard setters—said entities should be permitted to apply the requirements retrospectively applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Two respondents gave specific reasons:
- (i) One national standard-setter said it had conducted outreach with some users of financial statements. Those users had said comparability between financial statement periods could be more useful than comparability between entities.
  - (ii) one accountancy body noted that the Board had not prohibited retrospective application in IFRS 15 and IFRS 16. The accountancy body expressed concerns that the lack of option could provide a precedent for future amendments.
30. A national standard-setter suggested an entity making a change as a result of the proposals would be making a change in an accounting estimate rather than a change in an accounting policy.
31. An accounting firm asked whether ‘contracts existing’ has the same meaning as the term ‘completed contracts’ used in the transition requirements of IFRS 15.
32. Another national standard-setter suggested the Board provide transition relief for first-time adopters. They said if a first-time adopter elects to apply the transition requirements in IFRS 1 *First-time Adoption of International Financial Reporting Standards* in relation to variable consideration applying IFRS 15, the basis used to recognise revenue and the basis used to assess whether the contract is onerous could be different.

**Staff Analysis***Permitting entities to apply IAS 8*

33. Paragraphs BC33–BC36 of the Exposure Draft explain why the Board decided not to require or permit retrospective application of the proposed amendments applying IAS 8. The Board noted:
- (a) it may be difficult for an entity to apply the proposed amendments without using hindsight. In situations where it is possible, such information may be costly to obtain.
  - (b) retrospective application of the requirements may not provide useful information to users of financial statements, because it does not provide trend information. This is because a contract typically becomes onerous only once in its life.
  - (c) providing an option for entities to apply the amendments retrospectively would introduce disproportionate complexity to the transition requirements and result in a possible loss of comparability across entities.
34. One respondent suggested that a benefit of permitting retrospective application applying IAS 8 (and, specifically, of restating comparative amounts) could be that it would improve comparability between periods. However, as noted above a contract typically becomes onerous only once in its life. Accordingly, permitting retrospective application of the amendments applying IAS 8 would result in a user obtaining information about contracts that existed in the comparative reporting period but do not exist at the beginning of the reporting period in which the entity first applies the amendments (ie contracts for which the entity fulfilled all its obligations in the comparative reporting period). Given that the entity has fulfilled all its obligations under those contracts, any information provided by restating comparative amounts would not be expected to provide useful trend information.
35. Since the publication of this Exposure Draft, the Board has published six other exposure drafts. The Board proposed different transition requirements in each one—ie some permit, some require and some forbid retrospective application of the respective proposals applying IAS 8. Accordingly, the proposed transition requirements in this Exposure Draft have not created a precedent for future amendments.

36. Finally, we note that only a few respondents disagreed with the Board's proposal to prohibit retrospective application applying IAS 8, and those respondents were matched by an equal number of respondents who explicitly agreed with the Board's proposed transition requirements.

*Meaning of the term 'contracts existing'*

37. Paragraph C2(b) of IFRS 15 defines a 'completed' contract as a contract for which the entity has transferred all the goods or services identified in accordance with previous revenue recognition Standards. Some of the requirements of IFRS 15 need not be applied to completed contracts.
38. The Exposure Draft used the term 'contracts existing' to mean a contract under which an entity has one or more remaining obligations. If an entity has no further obligations, it is unlikely to incur any further costs and therefore that contract cannot be onerous.
39. The Board could clarify within the transition requirements that an entity applies the proposed requirements to contracts for which the entity has not yet fulfilled all its obligations under the contract at the beginning of the annual reporting period in which the entity first applies the amendments.

*Change in accounting estimate or accounting policy*

40. The Board is specifying transition requirements for the amendments and does not permit the application of IAS 8. Accordingly, an entity would not need to judge whether any change resulting from application of the amendments is a change in accounting estimate or a change in accounting policy—the entity would apply the transition requirements specified by the Board.

*First-time adopters*

41. The Exposure Draft proposed amendments to clarify the costs of fulfilling a contract; it did not propose to clarify the meaning of 'economic benefits' in the definition of an onerous contract.
42. The transition requirements referred to by the national standard-setter in paragraph 32 of this paper relate to how an entity determines revenue. Accordingly, those requirements may relate to how an entity determines the economic benefits it

expects to receive under a contract, however they do not relate to the Board’s proposals to clarify the costs of fulfilling a contract. For this reason, the suggestion by the national standard-setter is beyond the scope of the Board’s proposals in this project.

43. We also note that including transition requirements for first-time adopters in relation to economic benefits may imply a particular reading of economic benefits, which is not the Board’s intent in this project.

**Staff conclusion and recommendation**

44. We recommend that the Board:
- (a) does not permit the application of the proposed amendments retrospectively applying IAS 8;
  - (b) clarify within the transition requirements that an entity applies the proposed requirements to contracts for which the entity has not yet fulfilled all its obligations under the contract at the beginning of the annual reporting period in which the entity first applies the amendments; and
  - (c) does not provide any exception or exemption for first-time adopters.

**Question 3—transition requirements**

Does the Board agree with the staff recommendations set out in paragraph 44 of this paper?

## Appendix A—Staff analysis of other comments

A1. The following table provides a staff analysis of other comments:

Topic	Feedback overview	Staff analysis
1. Unavoidable costs	<p>Paragraph 68 of IAS 37 defines the unavoidable costs under a contract as ‘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>Some respondents provided the following suggestions regarding ‘unavoidable costs’:</p> <ul style="list-style-type: none"> <li>a) delete ‘unavoidable’ because, considered together with paragraph 19 of IAS 37 (which requires the recognition of only obligations arising from past events existing independently of an entity’s future actions), it indicates that the incremental cost approach is more appropriate.</li> <li>b) clarify whether the cost of fulfilling a contract need to be both unavoidable and direct, or whether ‘unavoidable costs’ refers to the lower of the two amounts.</li> <li>c) redefine ‘unavoidable’ so that an entity would determine whether the cost of fulfilling a contract or the</li> </ul>	<p>In our view, the Board should not make any of the amendments suggested in relation to ‘unavoidable costs’.</p> <p>As noted in paragraphs 25–26 of <a href="#">Agenda Paper 12</a> to the Board’s September 2019 meeting, we think the meaning of this phrase is consistent with the proposals in the Exposure Draft. That is, in the context of applying the IAS 37 onerous contract requirements, the Board has interpreted ‘unavoidable costs’ as those that an entity <i>cannot</i> avoid because it <i>has</i> the contract.</p>

	<p>penalties from failure to fulfil it best reflect the manner in which the entity is expected to satisfy its obligation.</p> <p>d) emphasise the cost of failure to fulfil a contract, rather than only any compensation and penalties arising from failure to do so.</p>	
<p>2. Timing of assessment or recognition</p>	<p>Individual respondents suggested:</p> <p>a) clarifying whether a contract can be onerous from inception or only when subsequent events occur.</p> <p>b) requiring an assessment of whether a contract is onerous only when factors indicate that this might be the case.</p> <p>c) specifying when an entity recognises an onerous contract.</p>	<p>We think the existing requirements in IAS 37 are sufficient to address when an onerous contract exists and when the entity recognises that onerous contract.</p> <p>Accordingly, we recommend not adding any new requirements to IAS 37 as part of this project to address these matters.</p>
<p>3. Requests for other clarifications</p>	<p>A few respondents suggested that the Board:</p> <p>a) conduct a comprehensive review of IAS 37 to clarify the principles for discounting in the measurement of provisions.</p> <p>b) provide examples of the information an entity might disclose about onerous contracts to meet the requirements in paragraph 85(b) of IAS 37 and</p>	<p>As part of its Provisions research project, the Board is considering the measurement requirements in IAS 37, and in particular considering the effect of an entity’s own credit risk on the discount rate applied in measuring provisions.</p> <p>Paragraph BC30 of the Exposure Draft notes that the Board is not proposing any new disclosure requirements as part of this project. Providing an example of what information an</p>

	<p>paragraph 125 of IAS 1 <i>Presentation of Financial Statements</i>.</p> <p>c) clarify the link between the cost of fulfilling a contract in IFRS 15 and the presentation of ‘cost of sales’ when presenting expenses by function.</p>	<p>entity might disclose applying the existing requirements in IAS 37 is beyond the scope of the project. Accordingly, we recommend the Board does not do so.</p> <p>Clarifying the interaction between IFRS 15 and the presentation of ‘cost of sales’ when presenting expenses by function is beyond the scope of the project. Accordingly, we recommend no further action in this regard.</p>
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