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## IASB<sup>®</sup> meeting

Date	<b>July 2023</b>
Project	<b>Provisions—Targeted Improvements</b>
Topic	<b>Costs to include in measuring a provision</b>
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## Purpose of session

1. The purpose of this session is to decide whether to propose an amendment to the measurement requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The amendment would specify which types of costs an entity includes in measuring a provision.

## Background

### ***IAS 37 measurement requirements***

2. Paragraph 36 in IAS 37 states that ‘the amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period’.
3. Other IFRS Accounting Standards require an entity to measure a non-monetary asset or liability by reference to the costs the entity has incurred to purchase or manufacture the asset, or the expenditure it will incur to settle the liability. Most of those Standards specify the types of costs to include, for example, specifying that those costs include

not only the incremental costs but also other directly related costs. Some of the Standards also list examples of the types of costs that are included or excluded.<sup>1</sup>

4. In contrast, IAS 37 is silent on what it means by ‘expenditure’, leaving scope for diversity in practice—especially in relation to obligations an entity settles by providing goods or services as opposed to paying cash.

### ***Onerous contracts amendment***

5. In May 2020, the IASB issued a narrow-scope amendment to IAS 37. This amendment added paragraph 68A to IAS 37, specifying which costs an entity includes in assessing whether a contract is onerous, and hence in assessing whether the entity needs to recognise an onerous contract provision.
6. 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. IAS 37 also states that the unavoidable costs 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.<sup>2</sup>
7. Paragraph 68A specifies that the cost of fulfilling a contract comprises the costs that relate directly to the contract. It also states that such costs consist of both:
  - (a) the incremental costs of fulfilling the contract—for example direct labour and materials; and
  - (b) an allocation of other costs that relate directly to fulfilling contracts—for example, an allocation of the depreciation charge for an item of property, plant and equipment used in fulfilling that contract among others.

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<sup>1</sup> See for example: paragraphs 95–98 of IFRS 15 *Revenue from Contracts with Customers*, paragraphs 10-16 of IAS 2 *Inventories*, paragraphs 16-22 of IAS 16 *Property, Plant and Equipment* and paragraphs B65-B66 of IFRS 17 *Insurance Contracts*.

<sup>2</sup> Paragraph 68 of IAS 37.

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8. The IASB decided to require entities to include all costs that relate directly to the contract (instead of only the incremental costs of fulfilling the contract) on the basis that:
- (a) including all such costs provides more useful information to users of the entity's financial statements;
  - (b) the benefits of providing that information are likely to outweigh the costs; and
  - (c) a requirement to include all costs that relate directly to a contract is consistent with other requirements in IAS 37 and requirements in other IFRS Standards.
9. Paragraphs BC4–BC13 of the Basis for Conclusions accompanying IAS 37 explain these reasons more fully. They are reproduced in the appendix to this paper.

### ***Stakeholder requests for clarification***

10. While the IASB was conducting the project to develop the onerous contracts amendment, some stakeholders asked it to expand the scope of that project to clarify other aspects of the onerous contract requirements in IAS 37. Stakeholders asked the IASB to clarify, among other things, whether an entity is required:
- (a) to measure an onerous contract provision by including the same costs as it uses to identify the contract as onerous; and
  - (b) to include the same types of costs in measuring *other* types of provisions within the scope of IAS 37.
11. The IASB decided not to address these questions at that time because doing so would have delayed the issue of an amendment regarded as urgent. The IASB stated in the Basis for Conclusions that the amendments 'therefore do not change the requirements in IAS 37 beyond clarifying the costs an entity is required to include in assessing whether a contract is onerous'.<sup>3</sup>

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<sup>3</sup> Paragraph BC19 of the Basis for Conclusions accompanying IAS 37.

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12. While scoping this current project to make targeted improvements to IAS 37, the IASB consulted various groups of stakeholders on which matters to address within the project. The IASB suggested the project should include clarifying the implications of the onerous contract amendment for the measurement of both onerous contract and other types of provisions. All stakeholders who expressed a view agreed with the suggestion.

***Guidance published by large accounting firms***

13. Some accounting firms refer in their published guidance to the implications of the onerous contracts amendment for measurement of onerous contract provisions:
- (a) one firm expresses its view that an onerous contract should be measured using the same principles as those used for determining whether that contract is onerous; and
  - (b) another firm advises that although the amendment is part of IAS 37's recognition requirements for onerous contracts, rather than its measurement requirements, entities could reasonably decide that the same costs are also used to measure any onerous contract provision recognised.

**Staff analysis and conclusions**

***Reasons for clarifying the measurement requirements***

14. The requests for clarification (discussed in paragraphs 10–12) and the advice provided by accounting firms (discussed in paragraph 13) suggest there remains scope for doubt about the implications of the onerous contracts amendment for measurement of onerous contract and other types of provisions. This doubt could be removed by specifying the costs an entity includes in measuring a provision—ie in estimating ‘the expenditure required to settle the present obligation’.

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***Reasons for specifying the same costs as those included in assessing whether a contract is onerous***

15. If the IASB specifies which costs to include in measuring a provision, we think it should specify that the expenditure required to settle the present obligation comprises the costs that relate directly to settling that obligation. It could do so on the basis that:
- (a) it is logical that the measure of an onerous contract provision includes the same costs as those included in determining whether the contract is onerous—not only the incremental costs of fulfilling the contract. If only the incremental costs of fulfilling an onerous contract are included in the measure of the provision, there could be circumstances in which no provision is recognised even if the contract is determined to be onerous. This outcome could occur in cases where the incremental costs are less than the economic benefits expected to be received under the contract. Measuring an onerous contract provision using different costs from those used to identify the contract as onerous results in inconsistency between the recognition and the measurement of the provision.
  - (b) the reasons for specifying that the costs of fulfilling an onerous contract include all costs that relate directly to the contract (see paragraphs BC4–BC13 reproduced in the appendix to this paper) would equally apply to the costs of settling other types of obligations.

**Staff recommendation**

16. The staff recommend that the Board propose to specify in IAS 37 that:
- (a) the expenditure required to settle an obligation comprises the costs that relate directly to settling the obligation; and
  - (b) the costs that relate directly to settling an obligation consist of both:
    - (i) the incremental costs of settling the obligation; and
    - (ii) an allocation of other costs that relate directly to settling obligations of that type.

## Question for the IASB

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Do you agree with the staff recommendation in paragraph 16?

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## Appendix A – Excerpt from BASIS FOR CONCLUSIONS ON IAS 37 *PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS*

### **Onerous Contracts—Cost of Fulfilling a Contract (paragraph 68A)**

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BC1 In May 2020 the Board added paragraph 68A to IAS 37. Paragraph 68A specifies which costs an entity includes in determining the cost of fulfilling a contract for the purpose of assessing whether the contract is onerous. The Board added this clarification in response to a recommendation from the IFRS Interpretations Committee, whose research indicated that:

- (a) differing views on which costs to include could lead to material differences in the financial statements of entities that enter into some types of contracts.
- (b) the need for clarification was urgent. Following the withdrawal of IAS 11 *Construction Contracts*, entities are required to apply IAS 37 instead of IAS 11 to assess whether construction contracts are onerous. IAS 11 specified which costs to include, but IAS 37 did not.

#### **The cost of fulfilling a contract**

BC2 Views differed on what an entity should include in the cost of fulfilling a contract when assessing whether the contract is onerous—whether to include:

- (a) only the incremental costs of fulfilling the contract—for example, the cost of materials and labour required to construct a building; or
- (b) all costs that relate directly to the contract—both the incremental costs and an allocation of other costs that relate directly to fulfilling contracts—for example, an allocation of the depreciation charge for an item of property, plant and equipment used in fulfilling the contract among others, or an allocation of the costs of management and supervision of contracts.

BC3 The Board decided to require an entity to include all costs that relate directly to a contract. The Board concluded that:

- (a) including all such costs provides more useful information to users of the entity's financial statements (paragraphs BC4–BC7);
- (b) the benefits of providing that information are likely to outweigh the costs (paragraphs BC8–BC9); and

- (c) a requirement to include all costs that relate directly to a contract is consistent with other requirements in IAS 37 and requirements in other IFRS Standards (paragraphs BC10–BC13).

### Useful information

- BC4 An entity may obtain the resources it needs to fulfil a contract in different ways. For example, if an entity needs equipment to fulfil a contract to manufacture goods or provide services, it may either hire the equipment for use only on that contract, or buy the equipment and use it on several contracts. The Board concluded that to provide a faithful representation of the effect of a contract on an entity's financial position, the entity should identify the resources needed to fulfil the contract and include the cost of those resources, regardless of how it expects to obtain them. Including only incremental costs in that assessment—for example, the costs of hiring equipment but not an allocation of the depreciation of purchased equipment—would fail to recognise the costs of resources shared with other contracts.
- BC5 The Board considered contracts an entity will fulfil using existing assets with idle capacity. If the income from such a contract will exceed the incremental cost of fulfilling it, the contract will improve the entity's financial position and performance. But, unless the income will fully cover the cost of the capacity used, including that cost in assessing whether the contract is onerous might suggest otherwise because the entity will recognise an onerous contract provision and a loss when it incurs a present obligation by entering into the contract. If that capacity were not used to fulfil the contract, such a loss would not be recognised.
- BC6 The Board concluded that, even for a contract that will be fulfilled using existing idle capacity, including all costs that relate directly to the contract (that is, including the cost of the capacity used) provides useful information. By entering into a contract at a price that does not fully cover the cost of the capacity used, the entity has committed itself to using that capacity to provide goods or services at a price that would not be sustainable if all contracts were similarly priced. The entity has effectively committed itself to making a loss on that capacity for the life of the contract. In the Board's view, including the cost of the capacity used in assessing whether a contract is onerous provides information that is relevant to users of financial statements and faithfully represents the effect of the contract on the entity's financial position and performance. The Board noted that an entity would disclose additional information about the contract if such information is relevant to an understanding of the entity's financial statements.
- BC7 The Board also considered requirements in other IFRS Standards. Several IFRS Standards—such as IAS 2 *Inventories*—specify the costs to include in measuring a non-monetary asset. Although their detailed requirements differ, they all require an entity to include both the incremental costs of purchasing or constructing the asset, and an allocation of other directly



related or directly attributable costs, such as production overheads. The Board concluded that, in assessing whether a contract to deliver goods is onerous, the way an entity determines the cost of fulfilling the contract should be broadly consistent with the way it measures the cost of the goods when it holds them. Such consistency leads to more useful information.

### **Cost of applying the requirements**

- BC8 The Board discussed suggestions that it might be costly for a manufacturing entity to estimate and allocate all the costs that relate directly to a contract if the entity has not yet manufactured the goods it will deliver under the contract.
- BC9 The Board noted that IAS 2 requires an entity to measure the cost of manufactured inventories at an amount that includes both the incremental costs of production and an allocation of production overheads. Further, a manufacturing entity that enters into contracts to supply inventory is likely to need information about these costs to make pricing decisions. Therefore, the entity is likely to have already the information it needs to estimate and allocate the costs that will relate directly to contracts into which it has entered. The Board therefore concluded that a requirement to estimate and allocate costs that relate directly to a contract would not impose costs that outweigh the usefulness of the information provided.

### **Consistency with other requirements in IAS 37 and requirements in other IFRS Standards**

- BC10 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’. The Board concluded that the unavoidable costs of fulfilling a contract are the costs an entity cannot avoid because it *has* the contract (as opposed to the costs the entity could avoid if it *did not have* the contract). The costs an entity cannot avoid because it has a contract include both the incremental costs of that contract and an allocation of other costs that relate directly to fulfilling contracts, including that contract.
- BC11 The Board discussed whether including costs other than the incremental costs of fulfilling a contract would be inconsistent with other requirements in IAS 37. Those holding this view suggested that, because an entity will incur those other costs regardless of whether it fulfils the contract under consideration, the costs are not costs of ‘fulfilling the contract’—they are costs of operating the business. Paragraph 18 of IAS 37 specifies that no provision is recognised for costs that need to be incurred to operate in the future, and paragraph 63 prohibits recognition of future operating losses.
- BC12 However, the Board concluded that a requirement to include all costs that relate directly to a contract in assessing whether the contract is onerous is consistent with other requirements in IAS 37. It concluded that:

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- (a) in recognising an onerous contract provision, an entity would not be recognising a provision for the costs themselves—that is, it would not be identifying those costs as present obligations in their own right. Instead, the entity would be recognising its present obligation to deliver goods or provide services in exchange for other economic benefits, measuring that obligation at an amount that includes the cost of all the resources to be used to fulfil the obligation.
  - (b) paragraph 63 of IAS 37 prohibits an entity from recognising future operating losses because such losses are not liabilities; in other words, the entity does not have a present obligation to incur those losses. In contrast, in assessing whether a contract is onerous, an entity determines the cost of fulfilling its present obligation under an existing contract. Therefore, including all costs that relate directly to a contract in assessing whether the contract is onerous does not result in an entity recognising future operating losses.

BC13 The Board noted that a requirement to include all costs that relate directly to a contract is consistent with IFRS 17 *Insurance Contracts*. IFRS 17 requires insurers to include all costs that relate directly to the fulfilment of a contract in assessing whether an insurance contract is onerous. These costs include an allocation of fixed and variable overheads directly attributable to fulfilling insurance contracts.