

IFRS in Focus

IASB proposes to clarify onerous contract requirements

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This *IFRS in Focus* addresses the proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* set out in Exposure Draft ED/2018/2 *Onerous Contracts—Cost of Fulfilling a Contract* (ED) that has been published by the International Accounting Standards Board (IASB).

- The proposed amendments, if finalised, would add a statement to IAS 37 that the cost of fulfilling a contract comprises “costs that relate directly to the contract”. A list of examples for such costs would be added to IAS 37 for illustration.
- It is proposed that an entity applies the amendments to contracts existing at the beginning of the annual period in which the entity first applies the amendments. The effective date for the amendments will be set after the comment period ends.
- Comments on the proposals are requested by 15 April 2019.

Background

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 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.

IAS 37 is silent on which costs should be included in determining the cost of fulfilling a contract. It is particularly unclear whether the cost of fulfilling a contract comprises only the incremental cost of fulfilling that contract or instead also includes an allocation of other costs that relate directly to the contract.

Observation

IAS 11 *Construction Contracts* specified which costs an entity would include when identifying, recognising and measuring an onerous contract provision for contracts that were within its scope. IAS 11 has been superseded by IFRS 15 *Revenue from Contracts with Customers* for annual periods beginning on or after 1 January 2018. IFRS 15 does not include any onerous contract requirements.

Cost of fulfilling a contract

The IASB proposes to amend IAS 37 to specify that the cost of fulfilling a contract comprises the costs that relate directly to the contract. In addition, a list of examples is proposed that illustrates the types of costs an entity would include.

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For a contract to provide goods or services, that list would include:

- Direct labour
- Direct materials
- Allocations of costs that relate directly to contract activities (for example, costs of contract management and supervision; insurance; and depreciation of tools, equipment and right-of-use assets used in fulfilling the contract)
- Costs explicitly chargeable to the counterparty under the contract
- Other costs incurred only because the entity entered into the contract

General and administrative costs would be excluded under the proposed amendments as they do not relate directly to the contract unless they are explicitly chargeable to a counterparty under the contract.

Observation

The IASB has recently restarted its work on the research project to review IAS 37. The IASB considered to clarify the onerous contract requirements as part of that research project. However, it was decided that the withdrawal of IAS 11 has made the clarification of the onerous contract requirements urgent and the requirements should hence be specified in a separate project. The proposed examples are similar to those used in IAS 11 to identify contract costs.

Transitional provisions, effective date and comment period

The IASB proposes that an entity applies the amendments to contracts existing at the beginning of the annual period in which the entity first applies the amendments. An entity would not restate comparative information and would instead recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the start of the period when they are first applied.

The ED does not propose an effective date. The IASB will set the effective date for the amendments after the comment period ends. Application of the amendments before the effective date would be permitted.

The IASB requests comments on the ED by 15 April 2019.

Further information

If you have any questions about the proposed amendments to the onerous contract requirements in IAS 37, please speak to your usual Deloitte contact or get in touch with a contact identified in this *IFRS in Focus*.

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