**IASB documents published to accompany**

**IAS 37**

# Provisions, Contingent Liabilities and Contingent Assets

The text of the unaccompanied standard, IAS 37, is contained in Part A of this edition. Its effective date when issued was 1 July 1999. The text of the Accompanying Guidance on IAS 37 is contained in Part B of this edition. This part presents the following document:

**BASIS FOR CONCLUSIONS**

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*from paragraph*



 

# Basis for Conclusions on IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

*This Basis for Conclusions accompanies, but is not part of, IAS 37. IAS 37 was issued by the International Accounting Standards Committee in 1998 and was not accompanied by a Basis for Conclusions. This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (Board) in developing amendments to IAS 37. Individual Board members gave greater weight to some factors than to others.*

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

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:

(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.

## Examples

BC14 When it exposed draft amendments for comment, the Board proposed to include a list of examples of costs that do and do not relate directly to a contract. These examples were based on paragraphs 97–98 of IFRS 15 *Revenue from Contracts with Customers*.

BC15 Some respondents to the Board's draft amendments noted differences between the examples proposed and those in other IFRS Standards that specify which costs to include in measuring the cost of non-monetary assets. Those respondents asked the Board to clarify whether some costs mentioned in those other IFRS Standards would be regarded as costs that relate directly to the contract by an entity applying IAS 37. Respondents also asked the Board to provide examples of costs that relate directly to contracts other than contracts to deliver goods or provide services.

BC16 In response to this feedback, the Board decided to replace the list of examples with a more general description of the types of costs that relate directly to a contract—that is, the incremental costs of fulfilling the contract and an allocation of other costs that relate directly to fulfilling contracts. The Board concluded that the more general description:

(a) can be applied to all types of contract, rather than only to contracts to deliver goods or provide services;

(b) avoids unintended consequences of slight differences in the wording of examples in different IFRS Standards; and

(c) provides a framework within which an entity can judge whether a particular cost relates directly to a contract.

## Interaction with requirements for impaired assets

BC17 Paragraph 69 of IAS 37 requires that, before an entity establishes a provision for an onerous contract, the entity recognises any impairment loss that has occurred on assets 'used in fulfilling the contract'. Paragraph 69 originally referred to assets 'dedicated to that contract'. However, the term 'dedicated' could be read to apply only to assets used solely on that contract, and not used on other contracts. The Board amended the terminology in paragraph 69 to clarify that the requirement to recognise any impairment loss before establishing an onerous contract provision applies to all assets whose cost would be considered in assessing whether the contract is onerous.

## Scope

BC18 Some respondents to the Board's draft amendments asked the Board to expand the scope of the project to clarify other aspects of the onerous contract requirements in IAS 37, such as:

(a) measuring onerous contracts—whether an entity would consider the same costs in measuring a provision for an onerous contract as it would consider in assessing whether that contract is onerous.

(b) selecting a unit of account—whether, and if so when, an entity should combine groups of similar contracts or segment contracts into components when applying the onerous contract requirements.

BC19 The Board decided not to consider other aspects of the onerous contract requirements in IAS 37 because doing so would have prolonged the project, delaying the issue of amendments regarded as urgent (see paragraph BC1(b)). 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.

## Transitional provisions

BC20 On transition entities are required to apply the amendments only to contracts for which the entity has not fulfilled all its obligations at the date of initial application, without restating comparative amounts. The Board concluded that it may be difficult and costly for an entity to obtain the information needed to restate comparative amounts, and the information provided by doing so was unlikely to be sufficiently useful to justify the costs that the entity might incur.

BC21 The Board decided not to provide entities with an option to restate comparative amounts—that is, not to provide the option of retrospective application, as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The Board concluded that the benefits of providing that option would be limited, and would be outweighed by the complexity and possible loss of comparability between the financial statements of entities applying the amendments at their effective date.