How to account for onerous contracts when adopting IFRS 15?

1. What is the issue?

IFRS 15 Revenue from Contracts with Customers does not include specific guidance on the accounting for onerous contracts or on other contract losses. This standard withdraws IAS 11 so that accounting for these onerous contracts will now need to be performed under IAS 37 Provisions, Contingent Assets, and Liabilities to determine whether a contract in the scope of IFRS 15 is onerous.

> IAS 11 can no longer be applied to determine the onerous contract provision.

Under IAS 11 an entity that accounted for loss-making contracts considered the full cost of fulfilling the contract in assessing whether a contract is loss-making, e.g. the directly attributable variable costs and fixed allocated costs. Following the withdrawal of IAS 11, an entity applies IAS 37 in assessing whether a contract in the scope of IFRS 15 is onerous and considers only the 'unavoidable costs' of fulfilling a contract. Also the required provision is measured based on these 'unavoidable costs'.

Diversity in practice exists in determining the 'unavoidable costs' of meeting the obligations under the contract. In our view 'unavoidable costs' include incremental costs only, i.e. costs that an entity would not incur if it did not have the contract.

> Is it still possible to calculate the onerous contract provision in accordance with the 'full cost approach'?

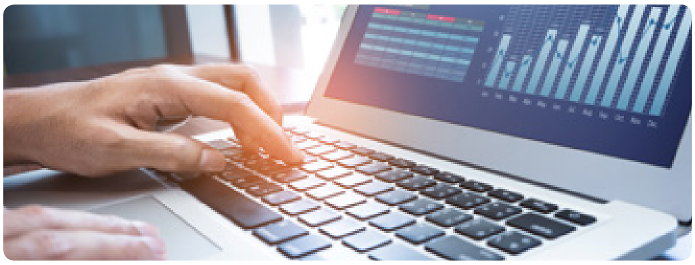
The IFRS Interpretations Committee (the 'Committee') discussed how to account for loss-making contracts that were previously accounted for under IAS 11, after IFRS 15 becomes effective. In particular, which costs should be considered in assessing whether a contract is onerous under IAS 37.

The Committee discussed how the term 'unavoidable costs' should be interpreted - i.e. which costs should be taken into account when assessing whether a contract is onerous, i.e. the 'incremental cost approach' or the 'full cost approach'. The Committee recommended the IASB to propose a narrow-scope amendment to IAS 37 to clarify that the 'cost of fulfilling' a contract comprises the 'costs that relate directly to the contract'. This may include costs that are not incremental. In order to clarify the meaning of 'unavoidable costs' and based on IFRIC's recommendation, the IASB decided to develop a narrow-scope amendment to IAS 37 and expects to issue an Exposure Draft in the last quarter of 2018.

2. What is the difference between the 'incremental cost approach' and the 'full cost approach'?

The 'incremental cost approach' corresponds only to the unavoidable costs directly associated with meeting the entity's obligations to deliver the goods or services under the contract. Under the 'incremental cost approach', the unavoidable costs of meeting the obligations under the contract are, in our view, only costs that:

- are directly variable with the contract and therefore incremental to the performance of the contract;
- do not include allocated or shared costs that will be incurred regardless of whether the entity fulfils the contract; and
- cannot be avoided by the entity's future actions.



Differently, the 'full cost approach' comprises other costs in addition to the ones included in the 'incremental cost approach'. These other costs are the full costs of meeting the obligations under the contract (in line with the IAS 11 method). These costs can include fixed and non-cancellable costs, such as depreciation of property, plant and equipment, non-cancellable operating lease costs and personnel costs for employees who would be retained.

> Under the 'incremental cost approach' the level of onerous contract provisions is expected to be significantly lower than under the 'full cost approach'.

In its July 2018 meeting, the Committee concluded that the 'cost of fulfilling' a contract should include both the incremental cost of fulfilling the contract and an allocation of other costs that relate directly to the contract (i.e. 'full cost approach').

However, in the narrow-scope amendments to IAS 37 the IASB still needs to specify that the 'cost of fulfilling' a contract comprises the 'costs that relate directly to the contract' and provide examples of costs that do, and do not, relate directly to a contract to provide goods and services.

3. What to do at year-end 2018?

Until the IASB completes the project of clarifying that the 'cost of fulfilling' a contract comprises the 'costs that relate directly to the contract', an entity that previously accounted for loss-making contracts under IAS 11 may, in our view, apply either of the two following approaches when identifying whether current and future contracts are onerous under IAS 37:

- consider the full costs of meeting the obligations under the contract, in line with its existing policy; or
- follow the 'incremental cost approach'.

These approaches correspond to the two possible ways discussed by the IFRS Interpretation Committee for applying the requirements in paragraph 68 of IAS 37 relating to the unavoidable cost of fulfilling the contract. It is important to note that by using one of these two approaches an entity applies a consistent accounting policy to all of its loss-making contracts, as highlighted by the Committee. For instance, if an entity has established a policy based on the incremental approach, then in our view it cannot change its accounting policy to the 'full cost approach'.

> In our view it is possible to continue to apply the 'full cost approach' and to measure the onerous contract provisions until the IASB project is completed.

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