

**Educational material 6**

**APPLICATION OF IFRS STANDARDS IN LIGHT OF THE  
CORONAVIRUS DISEASE (COVID-19) UNCERTAINTY  
Onerous contracts IAS 37**

**Issued 24 April 2020**

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### *Disclaimer*

*Please note that every effort has been made to ensure that the advice given in this educational material is correct. Nevertheless, that advice is given purely as guidance to members of SAICA to assist them with particular problems relating to the subject matter of the educational material, and SAICA will have no responsibility to any person for any claim of any nature whatsoever that may arise out of, or relate to, the contents of this educational material.*

## 1. Introduction

This educational material issued by SAICA's Accounting Practices Committee (APC) is prepared for educational purposes, highlighting the requirements within IFRS that are relevant for entities considering how the pandemic affects their accounting, for financial periods ending on or after 31 December 2019 with a specific focus on IAS 37 - *Provisions, Contingent Liabilities and Contingent Assets*.

Entities are reminded to consider the impact of events related to COVID-19 on both interim and annual financial statements.

This guidance does not change, remove nor add to, the requirements in IFRS. It is intended to support the sound, consistent and robust application of requirements in IFRS. It is of importance that IFRS is applied consistently on the basis of the most robust reasonable and supportable assumptions in the current environment.

## 2. Onerous contracts - Application of IAS 37.

This educational material sets out the financial reporting considerations arising from the events linked to the COVID-19 pandemic for onerous contracts due to shut down during the lock down period after the reporting period.

Future operating losses cannot be provided for as these do not meet the definition of a liability in terms of IAS 37 paragraph 10 and the general recognition criteria set out for provisions in IAS 37 paragraph 14 (IAS 37 paragraph 63, 64).

However, if an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision (IAS 37 paragraph 66).

An onerous contract is defined 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 paragraph 10).

The standard notes that many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. However, other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of the standard (unless specifically scoped out in paragraphs 1 to 5) and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of the standard (IAS 37 paragraph 67).

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 paragraph 68).

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 (IAS 37 paragraph 69).

To determine whether the events linked to COVID-19 are adjusting or non-adjusting, refer to SAICA's Educational Material 1 - *Application of IFRS Standards in Light of the Coronavirus Disease (COVID-19) Uncertainty - Events after the Reporting Period and Going Concern*. In the case where the events linked to COVID-19 are considered to be adjusting events after the reporting period, to determine whether onerous contracts exist at the reporting date, entities would need to carefully assess their contracts and agreements. Entities need to carefully identify and quantify any compensation or penalties arising from failure to fulfil the contracts.

Contracts should also be reviewed to determine if there are any special terms that may relieve an entity of its obligations.

Examples of contracts for which an onerous contract provision may be required include:

- Increased costs of fulfilling a contract with a customer under IFRS 15 with fixed prices due which may be due to but not limited to the following:
  - disruption to the global supply chain requiring changes in suppliers at higher costs; or the entity's inability to deliver the goods without procuring them from a third party at a significantly higher cost due to shutdown of its manufacturing facilities, or
  - the substitution of staff who are infected, subject to quarantine or are otherwise restricted from working.
- Revenue from contracts with customers when the contract as a whole, becomes onerous as a result of a penalty clause, a provision should be recognised for any net loss expected (refer below for treatment of penalties in contracts with customers).
- Lease contracts in the following circumstances (after commencement leases are treated under IFRS 16, refer below):
  - leases that become onerous before the commencement date of the lease; and
  - short-term leases (as defined in IFRS 16) and leases for which the underlying asset is of low value that are accounted for in accordance with paragraph 6 of IFRS 16, that have become onerous. (IAS 37 paragraph 5(c)).

Provisions should not be recognised under IAS 37 in respect of:

- Contracts that can be cancelled without paying compensation to the other party. These are not onerous as there are no obligations placed on the entity.
- Penalties for failure to respect the terms of a revenue contract, such as late delivery penalties. These penalties are accounted for under IFRS 15 as they are a form of variable consideration that affects revenue.

- Leases (other than short-term leases and leases of low value assets referred to above) that become onerous after their commencement date. These leases are dealt by applying the general requirements of IFRS 16 (impairment of ROU asset).
- Future operating losses.

### **Practical examples:**

The examples are based on the following background. The office of a company is closed for at least three weeks commencing 27 March 2020 due to the lock down. The company must continue paying rent, electricity, security, etc., but there will be no revenue or benefit to the company during the period.

Does the company have to account for an onerous contract if they have a December 2019 or January/February 2020 year-end? And how is March 2020 impacted?

It is important to note that there may be different results depending on whether the electricity, security, etc. are part of the lease agreement or separate agreements.

- If the lease agreement is accounted for under IFRS 16.
  - IFRS 16 is scoped out of IAS 37, therefore the rental should continue to be accounted for under IFRS 16.
- If the company accounts for the lease agreement under the recognition exemption in IFRS 16 as a short-term lease.
  - As it is not accounted for under IFRS 16, it would fall within the scope of IAS 37.
  - For December 2019, January 2020 and February 2020 year-ends, no onerous contract to be accounted as the lock down was announced after year-end. This is a non-adjusting event (refer to SAICA's Educational Material 1 - *Application of IFRS Standards in Light of the Coronavirus Disease (COVID-19) Uncertainty - Events after the Reporting Period and Going Concern*).
  - For March 2020 year-ends, there may be an onerous contract if the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received. A calculation would need to be performed comparing the unavoidable cost of rental under the contract to the income to be generated over the same period of the contract. If the company is expected to return to generating income after the lockdown period, but still within the term of the contract, the contract might not be onerous. The onerous contract may need to be accounted for if the unavoidable costs of meeting the obligations in the lease agreement exceed the income to be generated.
- The company has a 4-year lease entered into 3-years ago and used the 12-month remaining exemption on adoption of IFRS 16 which became effective for year ends beginning on or after 1 January 2019.

- The 12-month remaining exemption is only available on adoption of IFRS 16. Therefore, these short-term leases will end during or at the end of the year IFRS 16 has been adopted.
- For all year-ends to March 2020, the full cost would have been recognised and no further action required.
- For entities with a year-end after March 2020, this needs to be assessed for their interim reporting if that has not been finalised. If the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received, the onerous element must be accounted for. (Effectively this would be for March, April and May interim periods for entities with a September 2020, October 2020 or November 2020 year-end)
- The electricity, security, etc. are separate contracts.
  - For December 2019, January 2020 and February 2020 year-ends, no onerous contract to be accounted as the lock down was announced after year-end. This is a non-adjusting event (refer to SAICA's Educational Material 1 - *Application of IFRS Standards in Light of the Coronavirus Disease (COVID-19) Uncertainty - Events after the Reporting Period and Going Concern*).
  - For March 2020 year-ends, the contracts must be assessed to determine whether there is an onerous element. Are the unavoidable costs of meeting the obligations under the contract exceeding the economic benefits expected to be received? 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.
  - Some of these contracts are short-term and can be cancelled with/without penalty. Contracts that can be cancelled without paying compensation to the other party are not onerous as there are no obligations placed on the entity.
  - The onerous contract may need to be accounted for if the unavoidable costs of meeting the obligations in the contract exceed the income to be generated.