Exposure Draft

Onerous Contracts – Cost of Fulfilling a Contract

(Amendments to Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets)

Application of the recognition and measurement rules

Onerous contracts

68A The cost of fulfilling a contract comprises the costs that relate directly to the contract. Costs that relate directly to a contract consist of both:

(a) the incremental costs of fulfilling that 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.

Comments: The changes are on par with IAS17. The amendments will provide greater clarity to companies and help ensure the Standard is applied consistently. The changes are most relevant for companies in the manufacturing, construction and services sectors, and may result in some companies recognizing costs earlier than previously.

However it may add-

To be capitalized, organizations may have to first assess whether the cost in question is covered by other guidance and it must meet three criteria:

(1) the cost is directly related to a current or a specific anticipated contract;

(2) the cost generates or enhances a resource that is used to fulfill performance obligations; and

(3) the cost is recoverable.

Contract fulfillment costs may be categorized as: Set-Up Cost, Learning Curve Cost & Abnormal Cost. Since a company would defer some contract fulfillment costs, a company's income statement may reflect a higher net income in the year that contract fulfillment costs are capitalized. In some cases, if some or all of the revenue is constrained in a contract, then the company would recognize an upfront loss even when the related performance obligation is satisfied. Amortization of contract costs is no longer associated with revenue recognition of nonrefundable upfront fees. As a result, capitalized contract costs may be amortized over a longer time period than they would be previously.

Transitional Provisions:

94A Onerous Contracts—Cost of Fulfilling a Contract, added paragraph 68A and amended paragraph 69. An entity shall apply those amendments to contracts for which it has not yet fulfilled all its obligations at the beginning of the annual reporting period in which it first applies the amendments (the date of initial application). The entity shall not restate comparative information. Instead, the entity shall recognize 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 date of initial application.

Comments: It is same as IAS 17. It seems the amendment has decided not to provide entities with an option to restate comparative amounts—that is, not to provide the option of retrospective application, since 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.

Further 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.

Therefore the proposed amendment is in order.