



MFRS News

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MFRS News is your monthly update on all things relating to Malaysian Financial Reporting Standards. We'll bring you up to speed on topical issues, provide comment and points of view and give you a summary of any significant developments.



MASB looks to clarify MFRS 137's onerous contracts requirements

MFRS 137 defines an onerous contract as one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received from it.

It goes on to state that 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.

The Standard does not however specify which costs to include in determining the cost of fulfilling a contract. In particular, it does not specify whether the cost of fulfilling a contract comprises only the incremental costs of fulfilling that contract, or instead also includes an allocation of other costs that relate directly to the contract.

Different views existed on this question, with the potential to result in material accounting differences. The issue has assumed increased importance recently as contracts that were within the scope of MFRS 111 'Construction Contracts' are now within the scope of MFRS 15 'Revenue from Contracts with Customers'. MFRS 111 specified which costs an entity would include when identifying an onerous contract provision for contracts that were within its scope but MFRS 15 does not include equivalent requirements. This means that for contracts within the scope of MFRS 15, entities will now look to MFRS 137 to assess whether a contract is onerous which magnifies the importance of the MFRS 137 wording.

These considerations have led the International Accounting Standard Board "IASB" (equivalent to MASB) to issue the Exposure Draft 'Onerous Contracts – Cost of Fulfilling a Contract'. In developing the Exposure Draft, the IASB considered two approaches to determining the cost of fulfilling a contract:

- a the incremental cost approach
- b the directly related cost approach.

The directly related cost approach differs from the incremental cost approach in that it includes all the costs an entity cannot avoid because it has the contract. Such costs include both the incremental costs of the contract and an allocation of other costs incurred on activities required to fulfill the contract such as insurance and depreciation of tools used in fulfilling the contract. By way of contrast, general and administrative costs do not relate directly to a contract unless they are explicitly chargeable to the counterparty under the contract.

The Exposure Draft proposes amendments that reflect the directly related cost approach. One of the principal reasons for this is that the incremental cost approach would fail to identify an onerous contract provision when an entity has several contracts that are expected to be profitable individually if the economic benefits are compared with only the incremental costs, but are loss-making once shared costs are included.

Retrospective application of the proposals would not be required under transition provisions set out in the Exposure Draft. Instead the transition provisions propose that an entity apply the amendments retrospectively from the date of first applying the amendments. This is in recognition of the fact that it might be difficult and costly for an entity to obtain the information needed to implement the proposed changes at the start of the earliest prior period presented, whilst not actually being impracticable to do so (as defined by MFRS 108).

Grant Thornton insight

The IASB hopes that clarifying the meaning of 'cost of fulfilling' will reduce any existing diversity in the application of the onerous contract requirements.

Changing to a policy of also including other costs that relate directly to the contract could however result in entities recognising onerous contract costs earlier. Contracts affected could include long-term service contracts.