NSW GOVERNMENT | Treasury

Guidance on Identifying Onerous Contracts - Natural Disasters and Covid-19

Introduction
This guidance identifies considerations arising from natural disasters and Covid-19, when identifying potential onerous contracts. The guidance therefore only provides a brief summary of the requirements in AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* (AASB 137), and agencies should refer to AASB 137 and TPP 20-01 *Financial Reporting Code for NSW General Government Sector Entities* where applicable, when accounting for onerous contracts.

Other Accounting Standards contain requirements for recognising provisions, including AASB 16 *Leases* (AASB 16), AASB 4 *Insurance Contracts*, and AASB 119 *Employee Benefits*.

AASB 137 Provisions, Contingent Liabilities and Contingent Assets (AASB 137)

> An *onerous contract* is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. [AASB 137.10]

Assessing economic benefits
The expected economic benefits under a contract may include future cash inflows and other direct and indirect benefits. Assessing future economic benefits in a not-for-profit public sector context, requires careful consideration and is discussed below.

Assessing unavoidable costs

> The unavoidable costs of meeting obligations, is the lower of:
> - The incremental costs of fulfilling the contract; or
> - Any compensation or penalties that would become payable, if the contract is exited or breached [AASB 136.68].

Where a contract can be cancelled without penalties or other costs, including compensation for non-performance, it is unlikely to be onerous. However, under a non-cancellable contract, there will often be penalty clauses or other legal mechanisms to compensate the parties. The penalty provisions may motivate a party to perform their obligations, but at a higher cost than anticipated.

Some contracts may contain force majeure clauses, that specify what happens if one or both parties are not able to perform their obligations, usually for events beyond their control. Agencies should carefully consider any force majeure clauses, because these may allow the contract to be cancelled or varied with much lower costs.

In assessing unavoidable costs, care should be taken to include all expected costs to complete or exit a contract. This may include the incremental costs to complete the contract as well as other unavoidable direct costs.

Before recognition of a provision for onerous contracts, assets involved in contract fulfilment need to be tested for impairment. If any impairment loss occurred on the assets dedicated to the contract, it should be recognised first [AASB137.69].

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Measurement of onerous contracts provisions

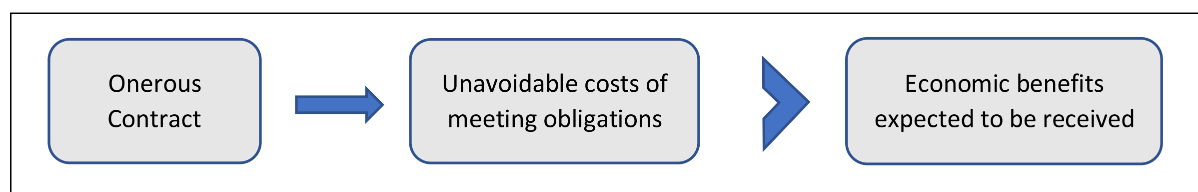
If an agency has an onerous contract, the present obligation under the contract must be recognised and measured as a provision [AASB 137.66].

It is expected that a provision for an onerous contract would be measured based on the unavoidable costs of meeting contract obligations and using the same approach that was used for determining whether the contract is onerous. For example, an entity may have a choice between producing goods or buying them in the market to fulfil a contract with a customer. The entity would use the lower costs of buying goods for assessing whether the contract is onerous and for determining the provision.

Reassessment of contracts in light of Covid-19

In the economic climate created by Covid-19, agencies should consider whether existing contracts have become onerous. These reviews should include identifying and assessing the impact of any force majeure clauses.

Management need to assess at each reporting date, whether circumstances exist that mean projected future costs are likely to exceed the projected future economic benefits across the entire remaining contract term. The impacts of natural disasters and COVID-19 on individual agencies and the economic environment, may lead to circumstances where onerous contracts now exist.



Specific requirements for lease contracts

AASB 137 does not apply where other Accounting Standards contain provisions for a specific type of provision, contingent liability or contingent asset. AASB 137 does not apply to leases after their commencement date, except for short-term leases and leases of low value assets [AASB 137.5(c)].

Instead, agencies should refer to AASB 16 for the requirements for leases and other Accounting Standards for other provisions. AASB 16 requires agencies to apply:

- AASB 136 *Impairment of Assets* to ROU assets where it is a lessee in a lease and owned assets where it is the lessor in an operating lease [AASB 16.33]; and

- AASB 9 *Financial Instruments* to the net investment in a lease, where it is a lessor in a finance lease.

Onerous lease contracts under AASB 137

A lease contract may become onerous <u>before the commencement date</u> of the lease. When a lessee is assessing whether a lease is onerous, the lessee should consider any sub-lease income that could be earned from the leased asset. This applies even when the agency chooses not to sub-lease the asset. However, if a lease prohibits sub-leases, then sub-lease income should not be considered.

For instance, an agency may plan to lease an asset from a third-party landlord and sublease it to external tenants. Lease payments to the landlord are expected to be higher than sub-lease income from tenants. Because the agency anticipates making a loss on the entire arrangement, before the

head lease commencement, the agency should consider recognising an onerous contract provision on entering the head lease.

Provisions for onerous contracts may also need to be recognised for non-lease components in lease contracts.

Examples of onerous contracts under AASB 137

In the current Covid-19 environment, the circumstances that lead to onerous contracts are more prevalent and there are circumstances not previously considered. Therefore, these typical examples of onerous contracts should not be considered exhaustive:

- Supplier with a non-cancellable sales contract containing penalties for non-delivery, where the entity is unable to fulfil the contract[1].
- Supplier with a non-cancellable sales contract where circumstances mean the costs of fulfilling the contract have increased, or are expected to increase, and are no longer expected to cover the expected consideration receivable. For example, higher costs due to Covid-19 related supply chain disruptions.
- Non-cancellable contract to rent property to provide lectures, where students are now not able to attend due to lockdown legislation.
- Non-cancellable long-term contract to purchase goods for resale, where the market price has fallen below the contract price, plus other costs to sell.

Public sector specific considerations

Assessing economic benefits

In the public sector, agencies commonly provide the public with goods and services for no charge or at heavily subsidised prices, as part of their fundamental functions of providing public services. Therefore, assessing the economic benefits expected to be received under a contract is not generally as straightforward as assessing future expected cash inflows.

Where a public sector agency enters into a contract that relates to social benefits, such as health, education, transport and other social services to the community, it is not expecting cash inflows as a result. Rather, the contract helps the agency fulfil its service objectives. The economic benefits are therefore equivalent to the extent to which the performance by the other party contributes to delivery of those service objectives.

This view is consistent with the AASB *Framework for the Preparation and Presentation of Financial Statements*. In paras. Aus54.1 and Aus54.2, the Framework acknowledges that not-for-profit entities may not receive cash inflows from an asset. But an asset will still have value via the utility or value of its outputs. The benefit to the not-for-profit entity, is enabling it to meet its objective of providing services to the beneficiary.

This does not mean a not-for-profit agency cannot have an onerous contract, only that assessing economic benefits under contracts means assessing more than expected net cash inflows. Determining whether a contract signed by a not-for-profit entity is onerous or not, requires significant professional judgement. Examples in the public sector are provided below.

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[1] If penalties envisaged in a sales contract do not result in the contract being loss making as a whole, the contract penalties are accounted for not under AASB 137 as onerous contract provisions but rather under AASB 15 *Revenue from Contracts with Customers* as part of variable consideration.

Example 1: Public sector Agency A signed a contract that commits it to supply a piece of imported medical equipment to another public sector entity B at a fixed price. Agency A needs to buy the equipment to fulfil the contract. Prices for this type of equipment in the international market increased due to Covid-19. Agency A does not need to recognise a provision for onerous contract, as long as the contract enables it to fulfil its objectives of providing medical supplies to other public sector entities, and this in turn enables them to provide medical services to the community.
Example 2: Public sector Agency B signed a non-cancellable contract with a third party for an office space lease which will commence in two-years time. The monthly lease fee is fixed in the contract. Due to Covid-19-related long-term reductions in demand for Agency B's services, Agency B no longer expects it will need the office space. Agency B expects that it will only be able to sublease the office space at a fee which is lower than the fee set in the contract. Accordingly, Agency B should recognise an onerous contract provision.

Disclosure of onerous contracts provisions

Agencies should refer to AASB 137 for full disclosure requirements. In particular, entities should disclose for each class of provision [AASB 137.84, 85]:

- a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
- the carrying amount at the beginning and end of the period and any changes during the period; and
- an indication of the uncertainties about the amount or timing of outflows of economic benefits. Where necessary, an entity shall also disclose the major assumptions made concerning future events.

As well as changes to estimates and assumptions, the current economic environment is likely to impact significant judgements and uncertainties over assumptions used in estimates. Therefore, additional disclosures should be considered in 2019-20 financial statements. AASB 101 *Presentation of Financial Statements* (AASB 101), contains requirements for disclosing material judgements and information about estimation uncertainty. Agencies should refer to AASB 101, in particular paras. 122 and 125 and Treasury Guidance *Disclosures in Financial Statements and Covid-19* for more guidance.