

What are Constructive Obligations and Onerous Contracts?

Worksheet

Under IAS 37, a constructive obligation exists when past practice, published policy or a specific current statement creates a valid expectation that the entity will act in a certain way; an onerous contract triggers a provision equal to the lowest net cost of exiting it.

Questions

1. What creates a constructive obligation?

- A) Only a signed contract
- B) Established past practice or a published policy creating valid expectations
- C) A court judgment
- D) Only tax legislation

2. An onerous contract exists when...

- A) Revenue exceeds costs
- B) Unavoidable costs exceed expected economic benefits
- C) The contract has expired
- D) No costs are involved

3. How is the provision for an onerous contract measured?

- A) Total remaining contract value
- B) The lower of fulfillment cost and exit cost
- C) Only the exit penalty
- D) Zero, no provision is made

4. Which of these is an example of a constructive obligation?

- A) A signed bank loan agreement
- B) A statutory tax liability
- C) A long-standing, publicized policy of refunding customers beyond the legal requirement
- D) A court-ordered fine

5. A retailer has no legal obligation to refund goods after 30 days, but has always done so for years and widely advertises this practice. A customer returns an item after 45 days. Should a provision be recognized?

6. A company signs a 5-year warehouse lease for \$120,000/year. After 2 years it stops using the warehouse; it cannot sublet it and the remaining lease payments total \$360,000 with no further economic benefit. Should a provision be recognized?

7. A company announces a detailed restructuring plan and communicates it to affected employees before year end, creating a valid expectation that the restructuring will happen. Estimated exit costs are \$500,000. Should a provision be recognized?

8. Define: What is a constructive obligation?

9. Define: What is an onerous contract?

10. Define: How is an onerous contract provision measured?

Answer Key

1. B) Established past practice or a published policy creating valid expectations - Constructive obligations arise from practice, policy or specific statements, not just legal instruments.
2. B) Unavoidable costs exceed expected economic benefits - By definition, an onerous contract's unavoidable costs outweigh its benefits.
3. B) The lower of fulfillment cost and exit cost - IAS 37 requires measuring at the lower of the two costs.
4. C) A long-standing, publicized policy of refunding customers beyond the legal requirement - This creates a valid expectation through practice, not a legal contract or law.
5. Assess whether a valid expectation has been created by consistent past practice and public communication
Conclude yes - this is a constructive obligation under IAS 37 Recognize a provision for the estimated cost of expected returns/refunds beyond the legal period
6. Compare the unavoidable costs of the remaining lease to any expected economic benefit (here, zero benefit since it can't be used or sublet) Since unavoidable costs exceed benefits, this is an onerous contract under IAS 37 Recognize a provision for the lower of the cost of fulfilling the contract and the cost of exiting it - here, \$360,000 (or any lower exit penalty if one exists)
7. Confirm a detailed formal plan exists and has been announced to those affected This creates a constructive obligation to carry out the restructuring Recognize a provision of \$500,000 for the direct costs of restructuring, excluding costs of ongoing activities
8. An obligation arising from established practice, published policy or a specific statement that creates a valid expectation in others, even without a legal requirement.
9. A contract where the unavoidable costs of meeting the obligations exceed the expected economic benefits.
10. At the lower of the cost of fulfilling the contract and the cost of exiting it (e.g. penalties for termination).

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