**Onerous Relationships** Written by Anesu Daka

An onerous relationship or contract is one in which the unavoidable costs under the contract exceeds the benefits received under the same contract. “Don’t mis-quote me LoL”, I am not referring to that relationship where one party is giving too much and the other is not appreciating and brings nothing, but all are bound by their wedding vows. Neither do I refer to my wonderful relationship to my wife, Tsitsi, without speaking for her though. I am a student and a teacher of International Financial Reporting Standards (IFRS), not a marriage counselor. However, if this figurative example vividly and effectively illustrates my point, then let it be.

Imagine a guy or a lady who unfairly terminates a courtship arrangement and is taken to court for compensation and the aggrieved party is awarded maintenance or alimony. The unavoidable costs are the alimony payments without any kind of “benefits” – there you go, if you thought accountants do not have a sense of humour. There are many such onerous relationships in business, and International Accounting Standards (IAS) 37 requires that an onerous provision/obligation be recorded and disclosed in financial statements.

Think of an entity that made a prior recruitment error (PRE) and is now stuck with a non-performing employee where it must honour promises under the burdensome Labour Act for very little benefits, if any at all. In other cases, the relations will be severed or irreparable, but an entity is obligated by court or arbitration to pay a salary to an employee who is at home. An onerous provision should be recorded and disclosed. Recording an expense as part of the normal monthly payroll payments is not correct and does not provide relevant and faithful representation of the events obtaining. Some of these relationships end up with punitive penalty payments inform of severance packages. Imagine one acquires a business which has a court battle with employees and the provision has not been recorded in full, only to be presented with a big bill to settle after taking over the business. This means the information presented was grossly misrepresented and misstated and would have influenced the decision on whether to buy or not.

Some examples of onerous relationships in the market include the following:

- Non-cancellable arrangements in which an entity is forced to continue because of a prohibitive penalty;
- Non-cancellable leases in buildings that are in bad locations;
- Customer loyalty obligations created on failed promotions; and
- Contract farming arrangements where the costs of production exceed the agreed price under the contract, etc.

The unforgivable sin under IFRS is to do cash basis accounting (recording expenses when cash is paid). Rather a provision should be recognized or accrued at the point at which the contracts becomes onerous by recording an expense upfront and a provision (obligation). This provides relevant information to users and would faithfully represent the economic consequence that the business finds itself in because of the onerous relationship, which cannot be achieved if cash basis accounting is done.

Dr Other expenses (P/L)
    Cr Onerous contract provision (SFP)
*Recording of the onerous obligation at point it becomes onerous*

Subsequently, the provision should be unwound for interest and adjusted for any payments made under the contract. Winding of interest is only relevant where there is significant time value of money effect. The discount rate used shall be a pre-tax rate that reflects current assessments of the time value and the risks specific to that liability. The following entries would be as follows:

Dr Interest expense (P&L)
    Cr Onerous contract provision (SFP)
*Recognition of unwinding costs*

Dr Onerous contract provision (SFP)
    Cr Bank (SFP)
*Payments made under the contract*

The onerous provision is measured at the lower of the:
- Cost of fulfilling the contract, and
- Penalty payable by the losing party for cancelling the contract

Taking our "real life" example again, the party paying the alimony has literary two options, and will normally chose the cheaper of the two:
- ✓ Reconcile with aggrieved party, have a beautiful wedding and stay happily married ever after, or
- ✓ Just pay the alimony for the period spelt by the court ruling.

It has been observed that so many such relationship are prevalent, and entities are reporting them on a cash basis only, resulting in inadequate liabilities being recorded and full details being disclosed, hence affecting the '**usefulness**' of financial information reported. We therefore hope that this piece will help preparers of financial reports and auditors in reporting onerous relationships.

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***Note about the author***
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