STAFF PAPER

June 2017

IFRS Interpretations Committee Meeting

Project	**Costs considered in assessing whether a contract is onerous**		
Paper topic	Initial consideration		
CONTACT(S)	Craig Smith	csmith@ifrs.org	+44 (0)20 7246 6462

Introduction

1. The IFRS Interpretations Committee (the Committee) received a request to clarify which costs an entity considers when assessing whether a contract is onerous applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In particular, the submitter asks about the application of IAS 37 to contracts with customers previously within the scope of IAS 11 *Construction Contracts*.

2. The purpose of this paper is to provide the Committee with a summary of the staff's analysis and ask whether the Committee agrees with the staff recommendation not to add this matter to its standard-setting agenda.

3. This paper includes:

   a. background information;

   b. staff analysis; and

   c. staff recommendation.

4. The paper also has three appendices:

   a. Appendix A—Proposed wording of the tentative agenda decision.

   b. Appendix B—Submission.

   c. Appendix C—Unavoidable costs: comparison of views.

Background information

The submission

5. IFRS 15 *Revenue from Contracts with Customers* supersedes IAS 11. This means that, when an entity applies IFRS 15 to contracts with customers, such contracts previously within the scope of IAS 11 will be within the scope of IAS 37 when assessing whether those contracts are onerous.

6. The submitter asks for clarity as to which costs an entity considers when applying IAS 37 to contracts previously within the scope of IAS 11.

7. The submission, reproduced in Appendix B to this paper, outlines three possible views:

    a. View 1: the 'full costs' approach. This approach is equivalent to continuing to apply the requirements in paragraphs 16–21 of IAS 11 on contract costs.

    b. View 2: the 'directly attributable costs' approach. This approach uses the description of costs that relate directly to a contract in paragraphs 95–97 of IFRS 15.

    c. View 3: the 'incremental costs' approach. This approach refers to paragraph 68 of IAS 37, which specifies that an entity considers only the unavoidable costs of meeting the obligations under a contract. View 3 interprets 'unavoidable' to include only incremental costs of the contract.

8. IAS 11 is being withdrawn and therefore we think it would not be appropriate to continue to apply the requirements in that Standard.

9. In addition, paragraph BC296 of IFRS 15 explains that the Board decided not to include an onerous contract test in IFRS 15, and instead decided that entities should apply the existing requirements in IFRS Standards for onerous contracts (see paragraphs 12-16 of this paper for further information). Consequently, we think it would not be appropriate for an entity to apply paragraphs 95–97 of IFRS 15 when assessing whether a contract is onerous. Those requirements were written for a different purpose.

10. In our view, when an entity applies IFRS 15 to its contracts with customers, it is required to apply IAS 37 to those contracts when assessing whether they are onerous. The submitter agrees with this view, noting that the introduction of IFRS 15 brings contracts with customers previously within the scope of IAS 11 into the scope of IAS 37 when assessing whether they are onerous.

11. As a consequence, we think the underlying question in the submission is how to apply paragraph 68 of IAS 37 to contracts with customers, and specifically how to determine which costs are unavoidable costs of meeting the obligations under the contract. In particular, we think the submitter is asking whether entities can consider unavoidable costs applying IAS 37 to be the same as contract costs applying IAS 11.

IFRS requirements

Construction contracts

12. As noted in paragraph 5 of this paper, entities that have not yet adopted IFRS 15 apply IAS 11 to construction contracts. In addition paragraph 21 of IAS 18 *Revenue* refers to IAS 11 for contracts that an entity accounts for using the percentage of completion method. IAS 11 contains requirements for the recognition and measurement of contract costs, contract revenue and expected losses.

13. IFRS 15 was issued in May 2014. When IFRS 15 becomes effective on 1 January 2018, entities will be required to apply IFRS 15 to such contracts instead of IAS 11.

14. IFRS 15 includes requirements for the recognition and measurement of revenue and some costs. However, the Standard does not contain requirements for assessing whether such contracts are onerous.

15. Having considered including requirements for the recognition and measurement of onerous contracts in the revenue standard the Board decided that the requirements in IAS 37 could adequately identify onerous contracts (paragraph BC296 of IFRS 15).

16. IFRS 15 consequently amended IAS 37 by adding paragraph 5(g), which states:

> …However, as IFRS 15 contains no specific requirements to address contracts with customers that are, or have become, onerous, this Standard applies to such cases.

Requirements in IAS 37

17. Paragraphs 66–68 of IAS 37 include requirements for onerous contracts. Paragraphs 10 and 68 of IAS 37 include a definition of an onerous contract:

> 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.

Paragraph 68 goes on to say:

> 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.

18. When an entity identifies that a contract is onerous applying this definition, paragraph 66 of IAS 37 requires the entity to recognise and measure the onerous contract as a provision. Paragraphs 14–52 of IAS 37 specify recognition and measurement requirements for provisions.

19. Paragraph 14 of IAS 37 requires an entity to recognise a provision when:

    a. the entity has a present obligation (legal or constructive) as a result of a past event;

    b. it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

    c. a reliable estimate can be made of the amount of the obligation.

20. Paragraph 36 of IAS 37 requires an entity to measure a provision at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. Paragraph 37 of IAS 37 expands upon ‘best estimate of the expenditure required’:

> The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

Board projects on IAS 37

21. In June 2005 the Board published the Exposure Draft *Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits* (the 2005 ED). A further Exposure Draft M*easurement of Liabilities in IAS 37* was published in January 2010 (the 2010 ED). The Board did not finalise either of these Exposure Drafts and the project was suspended in 2010.

22. Neither Exposure Draft proposed clarifications to the definition of an onerous contract in IAS 37, nor did they provide further clarification of unavoidable costs. They did, however, propose some clarifying amendments to the measurement principles in IAS 37.

23. In the 2005 ED, the Board proposed to clarify that the basis of estimating many non-financial liabilities 'will be an expected cash flow approach, in which multiple cash flow scenarios that reflect the range of possible outcomes are weighted by their associated probabilities' (paragraph 31 of the 2005 ED).

24. Paragraph 36A of the 2010 ED again addressed measurement. It proposed to clarify how an entity would measure the amount that an entity would rationally pay to be relieved of an obligation.

The Board's most recent discussions

25. During the Board's 2015 Agenda Consultation, the Board considered whether to start a new project on IAS 37. In July 2015 the Board discussed Agenda Paper 14B, which highlighted potential problems with the requirements in IAS 37. That paper notes that IAS 37 is silent on the types of costs to include in a provision. Paragraphs 3.11-3.17 of the paper note that diversity exists in practice regarding the costs that entities include in a provision. Indeed, paragraph 3.13 of that paper says 'The practical implications of the lack of guidance in IAS 37 might become more pronounced when construction companies start to apply IFRS 15 instead of IAS 11. IFRS 15 contains no requirements for measuring onerous contract liabilities, with the result that in future entities will instead apply IAS 37'.

26. In addition, section 4 of the paper identifies a number of areas in which stakeholders have identified the need for clarification relating to onerous contracts. This includes clarification of which costs are considered 'unavoidable'.

27. We note that Agenda Paper 14B in July 2015 also identified other areas of diversity in applying the onerous contract requirements in IAS 37—for example:

    a. defining 'economic benefits';

    b. when a contract is onerous if it is the result of the entity's own decisions or actions; and

    c. whether an entity should ever divide a contract into components and apply the onerous contract test to each component separately.

28. Agenda Paper 22 from the April 2016 Board meeting summarises the feedback on the IAS 37 project as part of the Agenda Consultation. Having considered this feedback, the Board decided in May 2016 to add a project on Provisions to its research pipeline.

29. We are not aware of any events since May 2016 that would have reduced the identified diversity in practice. We did not, therefore, perform outreach for this submission because we think the research performed for the Agenda Consultation has provided sufficient information in this respect.

Staff analysis

Application of IFRS requirements

What are 'unavoidable costs of meeting the obligations under the contract'?

30. As noted in paragraph 11 of this paper, we think the submission is asking for clarity as to which costs are unavoidable costs of meeting the obligations under the contract, as described within the definition of an onerous contract in paragraph 68 of IAS 37. Paragraph 68 goes on to say 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 submission assumes that any compensation or penalties will be higher than the costs of fulfilling the contract, and thus the question asked addresses the costs of fulfilling the contract.

31. In our view, the unavoidable costs of meeting the obligations under the contract are costs that the entity cannot avoid because it has the contract. These costs would include costs such as the materials and labour to be used to fulfil the contract, depreciation (or an allocation of depreciation) of assets to be used to fulfil the contract, as well as any overheads needed to fulfil the contract. For example, an entity would consider whether a contract is of such magnitude that the level of employees working to complete the contract means that a central Human Resources (HR) function is needed to manage these workers. If this is the case, then the entity would include an appropriate allocation of the central HR function costs as unavoidable costs. Appendix C to this paper describes this view as View A, and outlines in more detail the types of costs that we would expect to be included as unavoidable costs.

Is there only one way to read unavoidable costs?

32. Although we view unavoidable costs as outlined above in paragraph 31 of this paper, the work on the Board's project on IAS 37 has identified that this is not the only way that unavoidable costs are interpreted in practice. We know that some entities view the unavoidable costs of meeting the obligations under the contract to be the incremental costs of having the contract, ie the costs that the entity would avoid (or not incur) if it did not have the contract.

33. These costs would include costs such as materials to be used to fulfil the contract and labour hired specifically to fulfil the contract. However, they would not include costs such as an allocation of depreciation if the asset used to fulfil the contract is also used for other purposes and thus the entity would incur the deprecation charge even if it did not have the contract. This would also be the case for labour costs that an entity would incur even if it did not have the contract. Appendix C to this paper outlines in more detail the types of costs that we would expect to be included.

34. This alternative view is similar to View 3 in the submission and is described in Appendix C to this paper as View B: incremental costs.

35. Without additional requirements or explanation beyond those in paragraph 68 of IAS 37, we think we cannot conclude that the view outlined in paragraph 31 above is the only way that stakeholders might reasonably read the requirements. As noted in paragraph 25 of the paper, IAS 37 is silent on which costs are costs of fulfilling a

contract. IAS 37 also does not have a basis for conclusions that might explain the Board's intention regarding unavoidable costs.

Application of IAS 37 to construction contracts

36. As noted in paragraph 11 of this paper, we think an underlying question in the submission is a request for clarity as to whether entities can consider unavoidable costs applying IAS 37 to be the same as contract costs applying IAS 11.

37. The analysis in Appendix C to this paper addresses this question. An entity would apply IAS 37, and not the withdrawn requirements in IAS 11, when assessing whether contracts to which it applies IFRS 15 are onerous. Nonetheless, the outcome of applying IAS 37 may not be very different from the outcome of applying IAS 11 with respect to the costs included in the onerous cost test. In particular this may be the case if the entity views unavoidable costs in IAS 37 as costs that cannot be avoided because the entity has the contract (View A in Appendix C).

38. In saying that, there are three additional factors to consider in applying IAS 37 to contracts that were previously within the scope of IAS 11:

    a. Applying IAS 11, an entity is required to compare contract costs to contract revenues to determine if the contract is onerous. Applying IAS 37, the unavoidable costs under the contract are compared to 'the economic benefits expected to be received' under the contract. As noted in Agenda Paper 14B to the Board's meeting in July 2015, there is diversity in how 'economic benefits' is applied in practice. Some take the view that economic benefits include only those that an entity will derive directly from the contract, whereas others take a wider view that economic benefits can also include other intangible benefits, such as access to future profitable contracts. Accordingly, an entity may view 'economic benefits' in IAS 37 to be different from 'contract revenue' in IAS 11.

    b. Paragraph 68 of IAS 37 says that the unavoidable costs under a contract are the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. Consequently, unlike IAS 11, an entity is required to consider whether any compensation or penalties payable for not fulfilling the contract would be lower than the cost of fulfilling it.

c. Paragraph 69 of IAS 37 requires an entity to recognise any impairment loss that has occurred on assets dedicated to a contract before establishing a separate provision for an onerous contract.

Question 1 for the Committee

1. Does the Committee agree with the staff analysis of the requirements in IFRS Standards on this matter as follows?
    a. When an entity applies IFRS 15 to its contracts with customers, the entity applies IAS 37 when assessing whether those contracts are onerous. Accordingly, when determining which costs to consider in assessing whether a contract is onerous, the entity no longer applies the previous requirements in IAS 11 regarding contract costs, nor does it apply the requirements in IFRS 15 on costs that relate directly to the contract.
    b. Applying paragraph 68 of IAS 37, the unavoidable costs of meeting the obligations under a contract are the costs that an entity cannot avoid because it has the contract. An entity might also interpret such unavoidable costs as the costs that an entity would not incur if it did not have the contract.
    c. In assessing whether a contract is onerous, an entity compares the unavoidable costs of meeting the obligations under the contract to the economic benefits expected to be received under it. If lower than the cost of fulfilling the contract, the unavoidable costs reflect any compensation or penalties arising from failure to fulfil it.

Should the Committee add this matter to its standard-setting agenda?

Is the matter widespread and expected to have a material effect on those affected?[1]

39. We think the research on the Board's project on IAS 37 has identified that this matter is widespread and that it could have a material effect on those affected. Paragraphs 21–29 of this paper summarise the relevant findings from the Board's project.

Is it necessary to add to or change IFRS Standards to improve financial reporting?[2]

40. We think that without additional requirements or explanation beyond those in paragraph 68 of IAS 37, we cannot conclude that our view of unavoidable costs, outlined in paragraph 31 of the paper, is the only way that stakeholders might reasonably read the requirements. As a consequence, we would conclude that it is necessary to change IAS 37 to address the matter.

Would any solution developed be effective for a reasonable period of time?[3]

41. The Board's project on Provisions in the research pipeline is expected to address this matter. Nonetheless, it is likely to be some time before the Board develops a proposed solution regarding IAS 37. We, therefore, think any solution developed by the Committee would be effective for a reasonable period of time.

Can the matter be resolved efficiently (is it sufficiently narrow in scope)?[4]

42. The Board's project on IAS 37 has identified that there are a number of questions on IAS 37 that are not easy to resolve, particularly regarding the measurement of provisions. In the light of this experience, if the Board or Committee were to undertake a standard-setting project on the matter submitted as an interim solution pending the Board completing its work on Provisions, we think that the scope of that project should be narrow.

---

[1] Paragraph 5.16(a) of the *Due Process Handbook*.

[2] Paragraph 5.16(b) of the *Due Process Handbook*.

[3] Paragraph 5.21 of the *Due Process Handbook*.

[4] Paragraphs 5.16(c) and 5.17 of the *Due Process Handbook*.

43. The narrowest scope possible, in our view, would be to undertake a project to clarify the meaning of 'unavoidable costs' in paragraph 68 of IAS 37. That clarification could, for example, add a definition or description that explains that unavoidable costs are those that an entity cannot avoid because it has the contract, and possibly give some examples of those costs. The benefit of such a project is that it would provide a framework within which entities could determine whether they should include particular costs in their assessment of whether a contract is onerous.

44. However, there is a question as to whether that benefit would be sufficient to justify adding a standard-setting project in this respect—there is always a cost for stakeholders when we propose to add to or change IFRS Standards. Although such a project would clarify unavoidable costs, it would not respond to other questions about the definition of an onerous contract that have been identified as part of the Board's project on IAS 37 (see paragraph 27 of this paper)—most notably, how to interpret 'economic benefits'.

45. The Committee could, therefore, consider undertaking a project that would clarify both economic benefits and unavoidable costs, and possibly also address the other identified questions on the assessment of whether a contract is onerous. However, in our view, the scope of such a project would then no longer be sufficiently narrow and would not necessarily be easy to resolve. We are aware that there are long-held divergent views on some of these questions. In addition, such a project would clarify only the assessment of whether a contract is onerous, it would not then go on to address the measurement of any onerous contract provision.

Staff conclusion, having considered the Committee's agenda criteria

46. Having considered the agenda criteria in paragraphs 5.16-5.17 of the *Due Process Handbook* (as discussed above in paragraphs 39–45), we think that the matter cannot be resolved efficiently.

47. The Board is already aware of this matter and intends to consider it as part of its project on Provisions within the research pipeline.

Staff recommendation

48. On the basis of our assessment of the Committee's agenda criteria, we recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend publishing an agenda decision that explains the requirements that an entity applies when assessing whether a contract is onerous.

49. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions 2 and 3 for the Committee
2. Does the Committee agree with the staff recommendation not to add this matter to its standard-setting agenda? 3. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

Appendix A

Proposed wording of the tentative agenda decision

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*—Costs considered in assessing whether a contract is onerous

The Committee received a request to clarify which costs an entity considers when assessing whether a contract is onerous applying IAS 37. In particular, the submitter asked about the application of IAS 37 to contracts with customers previously within the scope of IAS 11 *Construction Contracts*.

When an entity applies IFRS 15 *Revenue from Contracts with Customers* to contracts with customers, the entity applies paragraphs 66–69 of IAS 37 in assessing whether those contracts are onerous. Accordingly, the Committee concluded that, when determining which costs to include in assessing whether a contract to which IFRS 15 is applied is onerous, the entity does not apply the previous requirements in IAS 11 on contract costs, nor does it apply the requirements in IFRS 15 on costs that relate directly to a contract.

The Committee observed that paragraph 68 of IAS 37 includes the definition of an onerous contract. In assessing whether a contract is onerous, an entity compares the unavoidable costs of meeting the obligations under the contract to the economic benefits expected to be received under it. If lower than any compensation or penalties arising from failure to fulfil the contract, the unavoidable costs reflect the cost of fulfilling the contract.

IAS 37 is silent on which costs are costs of fulfilling a contract. In applying paragraph 68 of IAS 37, the Committee discussed two interpretations of the unavoidable costs of fulfilling the contract:

a. unavoidable costs are the costs that an entity cannot avoid because it has the contract.
b. unavoidable costs are the costs that an entity would not incur if it did not have the contract.

The Committee concluded that these two interpretations are the only ways that the requirements in paragraph 68 of IAS 37 on unavoidable costs of fulfilling a contract could reasonably be read.

The Board's research pipeline includes a project on Provisions. This matter will be considered as part of that project. Nonetheless, in the light of its analysis, the Committee considered whether to add a project to its standard-setting agenda to narrow the possible ways of interpreting the requirements.

The Committee decided that amendments could not be developed for some of the requirements on onerous contracts separately from a comprehensive review of all of those requirements. With this in mind, the Committee concluded that it would be unable to resolve the question asked efficiently within the confines of existing IFRS Standards. Consequently, it [decided] not to add this matter to its standard-setting agenda.

Appendix B
Submission

B1. The submission has been reproduced below. We have deleted details that would identify the submitter of this request.

Issue: Which costs should be considered when determining the cost of fulfilling an onerous contract in terms of IAS 37?

IAS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received thereunder. Paragraph 68 of IAS 37 states 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. However, paragraph 68 does not provide any further guidance on the concept of unavoidable costs nor define what is meant by ‘cost of fulfilling the contract’.

At present, when recognising expected losses on a contract within the scope of IAS 11 *Construction Contracts*, that standard provides explicit guidance in paragraphs 16 – 21 on which costs are attributable to construction contracts. As such, for contracts within the scope of IAS 11, there is currently little divergence in practice. The same guidance is used by preparers that make use of the percentage of completion method when prescribed by IAS 18, due to its cross reference to IAS 11.

Whilst paragraphs 95 to 97 of IFRS 15 define the costs to fulfil a contract within its scope, it contains no specific requirements to address contracts with customers that have become onerous. With the introduction of IFRS 15, a consequential amendment to IAS 37 brings such contracts into the scope of that standard. Currently entities applying IAS 11 (and IAS 18) use a “full costs” approach to loss-making contracts (as outlined in View 1 below). However, upon adoption of IFRS 15, which replaces IAS 11, it is unclear which of the approaches outlined below would be acceptable.

The following example illustrates the various possible treatments of an onerous construction contract with a customer under IFRS 15 and IAS 37:

Contract revenues (fixed)	100
Total costs	(120)
Direct material costs	40
Direct labour costs	15
Direct overhead costs (excl. depreciation)	45
Depreciation	10
Indirect overhead costs	10
Expected loss	(20)

For the purposes of this example, assume:

- any compensation or penalties arising from failure to fulfil the contract will be higher than the costs of fulfilling the contract;
- that the time value of money is not material; and
- that the plant and equipment used by the entity to fulfil this contract are

also being used to fulfil other construction contracts. The entity has determined that the recoverable amount of these assets exceeds their carrying amount (by virtue of the cash inflows from those other contracts) and, therefore, these assets are not impaired under IAS 36 *Impairment of Assets*.

View 1: 'Full costs' approach

This view follows an approach that is consistent with paragraphs 16 – 21 of IAS 11.

All contract costs that relate directly to the specific contract and those that are attributable to the contract activity should be included in the determination of fulfilment costs, i.e., CU120. This would include indirect overhead costs that are allocated to the contract.

Since the contract costs exceed the contract revenue, the contract is considered onerous. A provision of CU20 would be recognised.

Proponents of this view considered that the full costs approach, which is required under current IFRS (i.e., IAS 11) should continue to apply as this would be in line with what the

Boards had intended when developing IFRS 15. That is, the existing practice would not change. However, with the introduction of IFRS 15, IAS 11 will be withdrawn.

View 2: 'Directly attributable costs' approach

This view follows an approach based on the concept of costs that relate directly to a contract in paragraphs 95 to 97 of IFRS 15. Proponents of this view believe that the contract costs, as contemplated by IFRS 15, should be those costs that are considered in determining if a contract is onerous. Paragraph 97 of IFRS 15 considers these costs as being costs that are directly attributable to a contract.

As only the contract costs that are directly attributable to a contract should be considered when establishing the costs to fulfil, the indirect overhead costs of CU10 should be excluded in the example above. As these costs relate to the general operations of the entity, they are not considered to be directly related to the specific contract. Hence, as the indirect overhead costs are excluded in the assessment of whether the contract is onerous, the total costs to consider under this approach are only CU110.

Since the directly attributable contract costs exceed the contract revenue, the contract is considered onerous and a provision of CU10 would be recognised.

View 3: 'Incremental costs' approach

Proponents of this view consider that because IFRS 15 does not apply to onerous contracts, the measurement guidance in IAS 37 should be applied. Under this approach, only the **unavoidable costs** of meeting the obligations under a contract are included, as required by paragraph 68 of IAS 37. Proponents of this view consider that such costs are only those that are incremental to a specific contract and would exclude any costs that would still be incurred in the event that this contract were discontinued.

Therefore, the costs which are allocated to the contract of CU65 (including depreciation, direct overhead costs and indirect overhead costs) should not be taken into account when assessing whether a contract is considered onerous. In this example, depreciation has been treated as a non-incremental cost because in this example the asset is being used on multiple contracts. This may not be the case when an asset is acquired specifically for a particular contract (although in that case its carrying value would probably be impaired).

Therefore, the only costs to be considered in the example above under this approach are CU55 (being direct material and labour costs).

Since the contract revenue is higher than the incremental contract costs, the contract is not considered onerous. Therefore no provision is recognised. In this case the contract would remain in scope of IFRS 15 and a loss-making, but not onerous, contract would be measured under that standard.

Appendix C
Unavoidable costs—comparison of views

C1. The table below provides our analysis of whether the costs specified in paragraphs 16–20 of IAS 11 would be 'unavoidable costs' when applying the two views of unavoidable costs outlined in paragraphs 30–34 of this paper:

(a) View A— Costs that an entity cannot avoid. Our view of unavoidable costs.

(b) View B—Incremental costs. The alternative view of unavoidable costs.

C2. We note that paragraph 69 of IAS 37 requires entities to recognise any impairment on assets dedicated to the contract applying IAS 36 (eg property, plant and equipment or right-of-use assets) before establishing an onerous contract provision. Although paragraph 69 of IAS 37 does not directly refer to the impairment requirements for inventories in IAS 2 *Inventories* or the impairment requirements in paragraphs 101-104 of IFRS 15 for costs capitalised as costs to fulfil a contract, we think that an entity would also apply those requirements before establishing an onerous contract provision.

Key:

✓ Costs are unavoidable costs

✕ Costs are not unavoidable costs

? Cost may be unavoidable depending on the facts and circumstances

Types of Cost	View A—Costs that an entity cannot avoid		View B—Incremental costs	
Costs that are contract costs applying IAS 11				
IAS 11 paragraph 16 (a) costs that relate directly to the specific contract				
IAS 11 paragraph 17(a) site labour costs, including site supervision	If completion of a contract requires the entity to employ personnel or utilise existing employees, then these costs are unavoidable.	✓	If the entity would be required to hire employees to complete the contract, then an entity would not incur these costs without the contract and these costs would be unavoidable. In addition if the entity's workforce could be reduced without the contract then such costs would be unavoidable. However, if the entity had an existing workforce that would not change regardless of the entity completing the contract, then such costs are not unavoidable.	?
IAS 11 paragraph 17(b) costs of materials used in construction	If the entity is required to purchase raw materials or to use materials that it already owns to fulfil the contract, then these costs are unavoidable.	✓	If the entity were required to purchase raw materials to fulfil the contract, these costs are unavoidable. If the entity had already purchased the materials and they could be used on another project, we also think these costs are unavoidable.	✓

	IAS 11 paragraph 17(c) depreciation of plant and equipment used on the contract	If use of a particular item of plant and equipment is required to fulfil the contract, then we think it would be appropriate to allocate a portion of the depreciation on that asset as an unavoidable cost.	✓	Depreciation is a cost that would be incurred by the entity, even if it did not have the contract. Therefore an entity would not generally include depreciation as an unavoidable cost. An exception would be if the entity had purchased a particular item of plant and equipment specifically to fulfil this contract.	✗
	IAS 11 paragraph 17(d) costs of moving plant, equipment and materials to and from the contract site	The entity is required to move such items to the contract site to fulfil the contract. Therefore, these costs are unavoidable.	✓	The entity would not be required to move such items to the contract site if it did not have the contract. Therefore it would include these costs as unavoidable costs.	✓
	IAS 11 paragraph 17(e) costs of hiring plant and equipment	If the entity does not currently own the necessary plant and equipment and must hire them to fulfil the contract, then such costs are unavoidable.	✓	If the entity did not have the contract, it would not be required to incur these costs. They are therefore unavoidable.	✓
	IAS 11 paragraph 17(f) costs of design and technical assistance that is directly related to the contract	If the entity is required to incur design and technical assistance costs to fulfil the contract, such costs are unavoidable.	✓	If the design is specific to one contract, then the entity would be incurring design and technical assistance costs for that contract only. Therefore without the contract, such costs would be avoided. They are therefore unavoidable.	✓
	IAS 11 paragraph 17(g) the estimated costs of rectification and guarantee work,	If the entity has an obligation to rectify or guarantee work, then any associated costs are unavoidable.	✓	If the entity did not have the contract, then it would not have an obligation for rectification and guarantee costs. They are therefore unavoidable.	✓

	including expected warranty costs				
	IAS 11 paragraph 17(h) claims from third parties	Any such claims are the direct result of the entity having the contract, therefore they are unavoidable costs. Estimates of such costs are likely to be lower if the entity has taken out insurance. The entity would not consider as unavoidable costs any claims for which the entity has recognised a separate provision.	✓	If the entity did not have the contract, there would be no claims from third parties about the entity's work in delivering the contract. They are therefore unavoidable. An entity would not consider as unavoidable costs any claims for which the entity has recognised a separate provision.	✓
IAS 11 paragraph 16 (b) costs that are attributable to contract activity in general and can be allocated to the contract					
	IAS 11 paragraph 18(a) insurance	If the entity has purchased an insurance policy to cover specific performance obligations in the contract then such costs are unavoidable costs. However, if the entity does not have insurance the entity should consider the risk of claims from third parties in its analysis.	✓	If the entity did not have the contract, then it would not have incurred any directly related insurance costs. They are therefore unavoidable. However, general insurance costs would continue to be paid even if the entity did not have the contract. Therefore general costs would not be considered unavoidable.	✓
	IAS 11 paragraph 18(b) costs of design and technical assistance that are not directly related to a specific contract	Assuming that the design elements are required to fulfil the contract, it would be appropriate to allocate a portion of these costs to the contract.	✓	If these costs are not specifically incurred for this contract, then they would still be incurred without having the contract.	✗

	IAS 11 paragraph 18(c) construction overheads	If the cost can be allocated to the contract then it is presumably related to an activity required to fulfil the contract. Accordingly such costs are unavoidable.	✓	An entity would need to determine whether not having the contract would mean that it would not incur some of these overhead costs.	?
IAS 11 paragraph 16 (c) such other costs as are specifically chargeable to the customer under the terms of the contract					
	IAS 11 paragraph 19 may include some general administration costs and development costs for which reimbursement is specified in the terms of the contract	For general administration activities, an entity does not consider whether costs are specifically rechargeable under the terms of the contract when applying IAS 37. Instead, the entity considers whether the activities that generate those costs are necessary to fulfil the contract. If they are, then such costs are unavoidable. See the example of HR function costs in paragraph 31 of the paper.	?	General administrative costs are likely to be incurred regardless of whether the entity has the contract. Therefore they are likely to not be unavoidable. There may be some costs which have been incurred in fulfilling the contract that the entity could allocate to the contract, however, we would expect these to be included in costs defined in paragraph 16(b) of IAS 11.	✗
<u>Costs that are not contract costs applying IAS 11</u>					
	IAS 11 paragraph 20(a) general administration costs for which reimbursement is not specified in the contract	For general administration activities, an entity does not consider whether costs are specifically rechargeable under the terms of the contract when applying IAS 37. Instead, the entity considers whether the activities that generate those costs are necessary to fulfil the contract. If they are, then such costs are unavoidable. See the example of HR function costs in paragraph 31 of the paper.	?	General administrative costs not specified in the contract are likely to continue to be incurred regardless of whether the contract exists. Therefore in general we would not expect such costs to be unavoidable costs of having the contract. However, entities will need to consider each type of cost individually.	✗

	IAS 11 paragraph 20(b) selling costs	The entity has already incurred the selling costs on the contract and thus they are not unavoidable.	✗	The entity has already incurred the selling costs on the contract and thus they are not unavoidable.	✗
	IAS 11 paragraph 20(c) research and development costs for which reimbursement is not specified in the contract	If the research costs are for research is required to fulfil the contract, then such costs are unavoidable.	✓	This depends on whether the research and development costs are specific to the contract (although not reimbursable). This is unlikely but is possible. If the costs were being incurred specifically for the contract, they would be unavoidable costs of having the contract.	?
	IAS 11 paragraph 20(d) depreciation of idle plant and equipment that is not used on a particular contract	If the plant and equipment is idle, then it is presumably not used to fulfil the contract.	✗	If the plant and equipment is idle, then it is presumably not being used to fulfil the contract.	✗