IFRS

STAFF PAPER

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IFRS® Interpretations Committee Meeting

Project	Costs considered in assessing whether a contract is onerous (IAS 37)		
Paper topic	Items on the current agenda		
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This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee (Committee). Comments on the application of IFRS Standards do not purport to set out acceptable or unacceptable application of IFRS Standards—only the Committee or the International Accounting Standards Board (Board) can make such a determination. Decisions made by the Committee are reported in IFRIC® *Update*. The approval of a final Interpretation by the Board is reported in IASB® *Update*.

Introduction

1. In November 2017, the IFRS Interpretations Committee (Committee) decided to add a narrow-scope standard-setting project to its agenda. The objective of the project is to clarify the meaning of the term ‘unavoidable costs’ in the IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* definition of an onerous contract.

2. The main purpose of this meeting is to decide what requirements to propose. If the Committee agrees with the staff recommendation, we will also ask the Committee to decide the form of its standard-setting activity—whether to develop a draft Interpretation or propose narrow-scope amendments to IAS 37.

3. This paper includes:

    (a) a summary of staff recommendations (paragraph 5);

    (b) background information about the project (paragraphs 6–18);

    (c) staff analyses, conclusions and recommendations on four topics:

        (i) which costs are costs of fulfilling a contract (paragraphs 19–45)

        (ii) which overhead costs should be included (paragraphs 46–52);

(iii) examples (paragraphs 53–58); and

(iv) the form of standard-setting activity (paragraphs 59–67).

4. The Appendix outlines requirements of other IFRS Standards.

Summary of staff recommendations

5. 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. The staff recommend that the Committee:

(a) propose that in this context the ‘cost of fulfilling’ a contract should include both the incremental costs of fulfilling the contract and an allocation of overhead costs incurred for activities required to fulfil the contract;

(b) propose to specify that the ‘cost of fulfilling’ a contract comprises the ‘costs that relate directly to the contract’;

(c) include examples of costs that do and do not relate directly to a contract to provide goods or services; and

(d) develop its proposals as separate narrow-scope amendments to IAS 37, rather than as an Interpretation of IAS 37 or as part of the annual improvements process.

Background information

Request received

6. The Committee was asked about the costs an entity considers when assessing whether a contract is onerous applying IAS 37. In particular, the Committee was asked about the application of IAS 37 to contracts with customers that were previously within the scope of IAS 11 *Construction Contracts*. For financial periods beginning on or after 1 January 2018, such contracts will be within the scope of IFRS 15 *Revenue from Contracts with Customers*.

Requirements of IFRS Standards

7. IAS 11 contained specific requirements on the costs an entity should and should not include in identifying, recognising and measuring an onerous contract liability for contracts that were in its scope.

8. In contrast, IFRS 15 does not include requirements for identifying and measuring onerous contract liabilities. Instead, as noted in paragraphs 5(g) of IAS 37 and BC296 of IFRS 15, an entity applies paragraphs 66–69 of IAS 37 in assessing whether a contract to which it applies IFRS 15 is onerous. Accordingly, the Committee concluded that, when determining which costs to include in assessing whether such a contract is onerous, the entity does not apply the previous requirements in IAS 11 on contract costs, and nor does it apply the requirements in IFRS 15 on costs that relate directly to a contract. Instead, the entity applies the definition of an onerous contract in IAS 37.

9. 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 under it. 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, IAS 37 includes no further requirements on which costs to include in measuring the cost of fulfilling a contract.

IASB project to amend IAS 37

10. The International Accounting Standards Board (Board) has a project on provisions (IAS 37) in its research pipeline. In February 2018, the Board decided that the staff should restart and aim to complete that research project reasonably soon after the Board issues the revised *Conceptual Framework*, which the Board plans to issue in the next few weeks. When that research project is complete, the Board will discuss whether it should add to its work plan any project to amend IAS 37 and, if so, what the scope and timing of that project should be.

Previous Committee decisions

June 2017

11. In June 2017, the Committee noted two reasonable ways of reading 'unavoidable costs' in paragraph 68 of IAS 37:

    (a) unavoidable costs are the costs that an entity would avoid if it did not have the contract. Such costs are often referred to as 'incremental costs'.

    (b) unavoidable costs are the costs that an entity cannot avoid because it has the contract. Such costs would include, for example, an allocation of overhead costs if those costs are incurred for activities required to complete the contract.

12. The Committee considered whether to add a project to its standard-setting agenda to eliminate one of the possible ways of reading the requirements. At that meeting, it decided against doing so. It published a tentative agenda decision explaining its decision and identifying the two ways of reading the requirements.

September 2017

13. Eleven of the 12 respondents to the tentative agenda decision opposed it, taking the view that the Committee should undertake narrow-scope standard setting to reduce to one the possible ways of reading the term 'unavoidable costs'. Respondents argued that the impending application of IFRS 15 made standard-setting particularly necessary and urgent.

14. In September 2017, the Committee re-considered its tentative agenda decision in the light of both this feedback and the uncertain scope and timescale of the Board's project on IAS 37. The Committee also noted that a possible project to clarify the term 'unavoidable costs' in paragraph 68 of IAS 37 could be a discrete project that encompasses only a small part of the Board's wider research project on provisions, and thus should be capable of being completed on a more timely basis than any possible future project to amend other aspects of IAS 37.

November 2017

15. In November 2017, the Committee considered the feasibility and scope of possible narrow-scope standard-setting to address the questions raised in the request.

16. The Committee decided to add a project to its standard-setting agenda to clarify the meaning of the term ‘unavoidable costs’ in the IAS 37 definition of an onerous contract.

17. The Committee also reached decisions on the scope of the project. It decided that:

    (a) any new requirements should apply to all onerous contracts within the scope of IAS 37, not only contracts within the scope of IFRS 15.

    (b) the scope of the project should be restricted to clarifying the requirements for identifying onerous contracts. The scope should not include adding requirements for measuring onerous contracts.

    (c) the scope of the project should be to clarify only the term ‘unavoidable costs’ in the IAS 37 definition of an onerous contract—the scope should not include clarifying other aspects of the definition, such as the meaning of the phrase ‘economic benefits expected to be received’.

Consultation with the Board

18. At its December 2017 meeting the Board discussed the Committee’s decisions and had no specific comments, questions or suggestions for the Committee to consider.

Question 1—which costs are costs of fulfilling a contract

Introduction

19. Questions about the meaning of the term ‘unavoidable costs’ arise because IAS 37 does not specify which types of costs should be included in the ‘cost of fulfilling’ a contract.

20. IAS 37 applies to all onerous contracts except particular contracts (such as insurance contracts) for which there are onerous contract requirements in other IFRS Standards. Therefore, any requirements specifying the types of costs that make up the cost of fulfilling a contract would need to be operational for a variety of different contracts, including both sales contracts (for which the entity's obligation is typically to deliver goods or services) and purchase contracts (for which the entity's obligation is typically to pay cash).

21. However, questions about which costs make up the 'cost of fulfilling' a contract tend to arise primarily for contracts in which the entity's obligations are fulfilled by delivering non-monetary assets (such as goods or services). So, the analysis in this paper focuses on such contracts.

Staff analysis

22. In June 2017 the Committee identified two different approaches to identifying the costs that make up the cost of fulfilling a contact:

    (a) Approach A—include only the costs that the entity would avoid if it did not have the contract, ie the incremental costs of the contract; and

    (b) Approach B—include all the costs that the entity cannot avoid because it has the contract, including an allocation of overhead costs incurred for activities required to fulfil the contract.

Approach A—include only the incremental costs of the contract

23. Applying Approach A, the 'cost of fulfilling' a contract would include only the incremental costs of that contract.

24. In support of this approach, some stakeholders have argued that:

    (a) any other costs—that is, costs of resources that are shared across several contracts, or other overhead costs—will be incurred by the entity regardless of whether it fulfils that particular contract. So those other costs are not costs of 'fulfilling the contract'. They are instead costs that need to be incurred to operate in the future.

(b) including overhead costs in an onerous contract provision would be inconsistent with the general requirements of IAS 37:

(i) paragraph 18 of IAS 37 specifies that no provision should be recognised for costs that need to be incurred to operate in the future; and

(ii) even if the overhead costs are expected to give rise to operating losses, the expectation of losses would not be enough to justify recognising a provision for those costs. Paragraph 63 of IAS 37 prohibits recognition of provisions for future operating losses. Paragraph 64 explains that this is because future operating losses do not meet the definition of a liability.

25. A possible criticism of an incremental costs approach is that it would fail to identify an onerous contract liability if an entity has several contracts that are expected to be profitable individually at an incremental cost level but are onerous as a group once shared costs are taken into account:

Example 1

	Individual contract CU million	**Group of 10 contracts** CU million
Expected economic benefits	10	100
Incremental costs	(8)	(80)
Shared directly related costs	-	(50)
Profit/ (loss)	2	(30)

26. In this example, the entity expects to make losses of 30 million currency units on existing contracts but would not identify an onerous contract liability if it applied an incremental cost approach to assess individual contracts.

27. Such an outcome could be avoided by specifying that, if some of the resources required to fulfil contracts are shared across a group of similar contracts, onerous contract liabilities should be identified by considering the group of contracts as a whole. There is a precedent for such an approach within IAS 37. IAS 37 requires entities to recognise provisions if, among other things, it is probable that an outflow of resources will be required to settle the obligation. Paragraph 24 of IAS 37 states that 'where there are a number of similar obligations (eg product

warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligation as a whole'.

28. A possible criticism of a requirement to assess groups of similar contracts as a whole is that doing so could mask liabilities for contracts that are individually onerous. For example, suppose an entity has a group of ten similar contracts, but the expected incremental costs of fulfilling one of the contracts have increased to more than the expected economic benefits:

Example 2

	Nine contracts CU million	**One contract** CU million	**Group of 10 contracts** CU million
Expected economic benefits	90	10	100
Incremental costs	(72)	(12)	(84)
Shared directly related costs	-	-	(10)
Profit/ (loss)	18	(2)	6

29. If the contracts were assessed as a group, no onerous contract liability would be identified, despite one contract being onerous even at an incremental cost level.

30. Such an outcome could be avoided by modifying the incremental cost approach. The modified approach could require contracts to be assessed individually but to include the costs of shared resources if the costs of those resources will not be covered by other profitable contracts. Further application guidance is likely to be required to implement such an approach.

Approach B—include both incremental costs and an allocation of overhead costs

31. Applying Approach B, the costs of fulfilling a contract would include both the incremental costs of the contract and an allocation of overhead costs incurred for activities required to fulfil the contract.

32. To justify including an allocation of overhead costs, the Committee would need to address the argument that including them would be inconsistent with the general requirements of IAS 37—ie, that it would amount to recognising a liability for ‘costs that need to be incurred to operate in the future’ or ‘future’ losses (see paragraph 24(b)). The Committee could counter this argument by explaining that:

    (a) the entity would not be recognising a provision *for* the overhead costs. It would not be identifying these costs as present obligations in their own right. Instead the entity would be identifying its present obligation to deliver goods or services in exchange for other economic benefits, and measuring that obligation taking into account the full cost of the goods or services that it is obliged to deliver.

    (b) paragraph 63 prevents entities from recognising future operating losses on the grounds that such losses are not a liability, in other words that the entity does not have a present obligation to incur those losses. In contrast, in applying the onerous contract requirements the entity is determining the cost of fulfilling its present obligation in an existing contract to identify if that contract is onerous.

33. In support of an approach that includes both incremental costs or overhead costs, it can be argued that:

    (a) including both incremental costs and an allocation of other costs incurred for activities required to fulfil a contract provides the most faithful representation of the costs of fulfilling that contract. An entity can choose to obtain the resources it needs to fulfil a contract in different ways. For example, if an entity needs to use particular equipment to construct goods or deliver services, it could hire the equipment for the period required by the contract, or buy the equipment and use it for other contracts afterwards. Similarly, if it needs to prepare technical reports, it could engage a professional firm to prepare only the reports needed for an individual contract, or it could employ its own team of experts to prepare the reports for all its contracts. Either way, the entity incurs costs to obtain the use of the equipment or the information in the reports. Just because the entity chooses to buy its

own equipment or employ its own experts doesn't mean that the use of the equipment or information necessary to fulfil a contract are cost-free.

(b) ideally, the way in which an entity identifies the cost of fulfilling a contract to deliver goods should be consistent with the way in which it identifies the cost of those goods when it holds them. Consistency ensures that resources needed to fulfil a contract are measured in the same way regardless of whether the entity has yet obtained them. As explained in paragraphs 34–43 below, IFRS Standards that specify the types of cost to include in the measurement of a non-monetary asset all require the entity to include both the incremental costs of purchasing or constructing the asset and an allocation of directly related or directly attributable costs.

(c) applying an approach that includes an allocation of shared contract costs would lessen the need to specify circumstances, if any, in which entities should assess groups of similar contracts together, rather than individually. In Example 1 following paragraph 25, the entity would recognise the same onerous contract liability whether it assessed the ten contracts individually (loss after allocation of shared costs of CU3 million per contract) or as a group (total loss CU30 million). In Example 2, the entity would assess its contracts individually and identify a liability for its one onerous contract. These outcomes would be achieved without any need for the Committee to specify modifications to the basic requirements.

(d) recognising in an onerous contract provision the costs that the entity cannot avoid because it has the contract is consistent with the requirement in paragraph 80 of IAS 37 to recognise in a restructuring provision the costs that are 'necessarily entailed' by the restructuring.

Requirements in other Standards

34. Other IFRS Standards that specify the types of costs to include in the measurement of the cost of a non-monetary asset are:

    (a) IFRS 15 (for costs to fulfil a contract that are not within the scope of another Standard);

    (b) IAS 2 *Inventories*;

    (c) IAS 16 *Property, Plant and Equipment*;

    (d) IAS 38 *Intangible Assets*; and

    (e) IAS 40 *Investment Property*.

35. The Appendix details the costs that each of those Standards requires to be included in or excluded from the costs of the assets within their scope.

36. Paragraph 92 of IFRS 15 also requires entities to recognise as an asset the incremental costs of obtaining a contract. However, we have not considered these costs further because an entity must have already obtained a contract to have an onerous contract. Therefore, this requirement would not interact with the onerous contract requirements of IAS 37.

37. All the Standards listed in paragraph 34 use some notion of ‘directly related’ or ‘directly attributable’ costs when specifying which costs to include in the measurement of the cost of the asset. However, there are differences in terminology used to describe the costs:

    (a) IFRS 15 uses the phrase ‘costs that relate directly to a contract’ for identifying the costs to fulfil a contract that an entity should recognise as an asset;

    (b) IAS 2 uses the phrase ‘costs directly attributable to’ the cost of purchase of inventories but ‘costs directly related to units of production’ for costs of conversion; and

    (c) IAS 16, IAS 38 and IAS 40 all use the term ‘directly attributable’ to describe the costs included in the cost of property, plant and equipment, intangible assets and investment property.

38. The Standards all list similar examples of the types of costs that would meet the description of ‘directly related’ or ‘directly attributable’ costs. Examples include:

    (a) direct labour and material costs;

    (b) allocations of costs that relate directly to the contract or to contract activities;

    (c) other costs incurred in bringing an asset to its current location and condition; and

    (d) costs of testing whether the asset is functioning properly

39. All the Standards specify that entities should exclude ‘general overhead’ or ‘administrative’ costs, although with some exceptions. Exceptions are:

    (a) general and administrative costs that are explicitly chargeable to customers (IFRS 15).

    (b) administrative overheads that contribute to bringing inventories to their present condition and location (IAS 2).

    (c) administrative and other general overhead expenditure that can be directly attributed to preparing an internally generated intangible asset for use (IAS 38).

40. IAS 2 is the only Standard that requires entities to include ‘indirect’ costs. However, the only indirect costs that it requires to be included are indirect ‘costs of production’ and the examples it gives are similar to costs that IFRS 15 describes as costs that relate directly to a contract.. For example, the costs that IAS 2 describes as ‘indirect costs of production’ include depreciation and maintenance of factory buildings and the cost of factory management and administration. These are similar to the depreciation and contract management and supervision costs that IFRS 15 gives as examples of costs that relate directly to a contract.

41. Paragraph 22 of IAS 16 discusses assets that an entity constructs both for sale in the normal course of business (ie inventories) and to hold for use within its business (ie property, plant and equipment). It links their measurement, stating

that the cost of a self-constructed asset 'is usually the same as the cost of constructing an asset for sale (see IAS 2).'

42. Paragraph 47 of IFRS 17 *Insurance Contracts* contains requirements for onerous insurance contracts. Because onerous contracts within the scope of IFRS 17 are excluded from the scope of IAS 37, the two Standards do not interact so do not need to be consistent. However, ideally, their requirements would be similar, unless there are reasons for differences. The onerous contract test in IFRS 17 requires an entity to identify the 'fulfilment cash flows allocated to the contract'. Using terminology similar to that in IFRS 15, IFRS 17 defines the fulfilment cash flows using the phrase 'that relate directly to the fulfilment of the contract'. Paragraph B65 lists examples of fulfilment cash flows that are similar to those noted in paragraphs 38–39 above. Those requirements are included in the Appendix.

43. Thus, overall, Standards that specify the costs to be included in the measure of a non-monetary asset tend to specify the costs in similar ways. To be consistent with those other Standards, IAS 37 could specify that the 'cost of fulfilling' a contract includes both incremental costs and other costs that are directly related or directly attributable to the contract or contract activities.

Staff conclusion and recommendation

44. For the reasons in paragraphs 32, 33 and 43 the staff think that including in the 'cost of fulfilling' a contract both the incremental costs of fulfilling the contract and an allocation of overhead costs incurred for activities required to fulfil the contract would:

    (a) be consistent with other requirements in IAS 37;

    (b) result in a more faithful representation of the cost of fulfilling a contract than would result from including only incremental costs; and

    (c) enable the Committee to specify requirements in IAS 37 that are broadly consistent with those of other Standards.

45. Accordingly, the staff recommend that the Committee propose that in the context of paragraph 68 of IAS 37, the ‘cost of fulfilling’ a contract should include both the incremental costs of fulfilling the contract and an allocation of overhead costs incurred for activities required to fulfil the contract.

Question 1 for the Committee
Does the Committee agree that it should propose that, in the context of paragraph 68 of IAS 37, the ‘cost of fulfilling’ a contract should include both the incremental costs of fulfilling the contract and an allocation of overhead costs incurred for activities required to fulfil the contract?

Question 2—which overhead costs should be included

Introduction

46. If the Committee agrees with the staff recommendation in question 1 above, it will then need to consider whether and how to specify the types of overhead costs that should be included in the ‘cost of fulfilling’ a contract.

47. Two ways of describing those costs could be:

    (a) as ‘costs that an entity cannot avoid because it has the contract’—ie as described by the Committee in its tentative agenda decision published in June 2017; or

    (b) using one of the terms used in other Standards:

        (i) ‘costs that relate directly to a contract’;

        (ii) ‘directly related costs’; or

        (iii) ‘directly attributable costs’.

Staff analysis

48. Describing the cost of fulfilling a contract as the ‘costs that an entity cannot avoid because it has the contract’ would link the new requirements with the definition of

an onerous contract as 'a contract in which the unavoidable costs…exceed the economic benefits…'. It would also help to clarify the meaning of the term 'unavoidable' which, as noted in paragraph 11, can be read in different ways.

49. However, the phrase 'costs that the entity cannot avoid because it has the contract' would need further clarification. Should an entity include only those costs that are directly related to contract activities? Or should it also include more general and administrative costs that it cannot avoid if it is to fulfil its contracts?

50. As explained in paragraph 33(b), there would be advantages to making the requirements in IAS 37 consistent with other Standards' requirements for measuring the cost of non-monetary assets. Consistency with other Standards would be achieved by specifying in IAS 37 that the cost of fulfilling a contract includes the costs that are directly related or directly attributable to the contract. If the Committee chooses to specify the costs in this way, there may be no need to also refer to the costs that the entity cannot avoid because it has the contract.

51. If the Committee wished to apply one of the terms used in other Standards, it would need to decide which term to use: costs that relate directly to the contract (IFRS 15 and IFRS 17), directly related costs (IAS 2) or directly attributable costs (IAS 2, IAS 16, IAS 38 and IAS 40). The Committee could choose 'costs that relate directly to the contract' on the grounds that the IFRS 15 and IFRS 17 requirements are the most closely related to the onerous contract requirements in IAS 37. In all three Standards, the requirements are specifying the costs of fulfilling a contract.

Staff conclusion and recommendation

52. For the reasons in paragraphs 48–51, the staff recommend that the Committee propose to specify that the 'cost of fulfilling' a contract comprises the 'costs that relate directly to the contract'.

Question 2 for the Committee
Does the Committee agree that it should propose to specify that the 'cost of fulfilling' a contract comprises the costs that relate directly to the contract?

Question 3—examples

Introduction

53. As discussed in paragraphs 34–43 of this paper IFRS 15, IFRS 17, IAS 2, IAS 16, IAS 38 and IAS 40 all include examples of costs that are included in and excluded from the cost of an asset. This section considers whether the Committee should include similar examples to help clarify the types of cost that an entity would include in assessing the ‘cost of fulfilling’ a contract applying IAS 37.

54. This section assumes that the Committee agrees with the staff recommendation in paragraph 51, ie that it should specify that the cost of fulfilling a contract comprises costs that relate directly to the contract. However, the examples chosen could be adapted if the Committee decided to describe the costs differently.

Staff analysis

55. It could be argued that there is a wide range of transactions within the scope of IAS 37 and it would be difficult to provide examples that are useful for all those transactions.

56. However, although it applies only to contracts with customers, IFRS 15 applies to a wide range of industries. Paragraph 97 of IFRS 15 lists examples of costs that relate directly to a contract. Paragraph 98 lists examples of costs that do not relate directly to a contract and so should be recognised as an expense when incurred. Therefore, it is possible to create general examples of costs that do and do not relate directly to a contract. Such examples could be useful.

57. The examples for IAS 37 could be based on the examples in IFRS 15, adapted to apply to contracts with counterparties other than customers. By way of illustration:

    (a) the examples in IFRS 15 of costs that relate directly to a contract could be amended as follows (new text is underlined and deleted text is struck through):

Costs that relate directly to a contract ~~(or a specific anticipated contract)~~ to provide goods or services include any of the following:

(a) direct labour (for example, salaries and wages of employees who provide the promised goods or services directly to the counterparty ~~customer~~);

(b) direct materials (for example, supplies used in fulfilling the contract ~~providing the promised services to a customer~~);

(c) allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance and depreciation of tools, equipment and right-of-use assets used in fulfilling the contract);

(d) costs that are explicitly chargeable to the counterparty ~~customer~~ under the contract; and

(e) other costs that are incurred only because an entity entered into the contract ~~(for example, payments to subcontractors)~~.

(b) the examples in IFRS 15 of costs that do not relate directly to a contract could be amended as follows (new text is underlined and deleted text is struck through):

~~An entity shall recognise the~~ The following costs do not relate directly to a contract ~~as expenses when incurred~~:

(a) general and administrative costs (unless those costs are explicitly chargeable to the counterparty ~~customer~~ under the contract, in which case an entity shall evaluate those costs in accordance with paragraph ~~97~~XX);

(b) costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract;

~~(c) costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (ie costs that relate to past performance); and~~

~~(d) costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).~~

Staff conclusion and recommendation

58. The staff think it would be helpful to include examples of costs that do and do not relate directly to a contract to provide goods or services, and so recommend including such examples.

Question 3 for the Committee
Does the Committee agree that it should include examples of costs that do and do not relate directly to a contract to provide goods or services?

Question 4—form of standard-setting activity

Introduction

59. In November 2017, the Committee decided to wait until it had reached decisions about the content of any proposals before deciding on the form of its standard-setting activity. If the Committee reaches decisions on the questions discussed earlier in this paper, it could also consider the form of its standard-setting activity at this meeting.

60. The Committee could develop a draft Interpretation of IAS 37, or propose amendments to IAS 37. Amendments could be made as part of the annual improvements process or as a separate narrow-scope project.

61. An Interpretation specifies how to account for particular transactions applying existing requirements, without changing those requirements.

62. Amendments made as part of the annual improvements process are limited to changes that either clarify the wording in a Standard or correct relatively minor unintended consequences, oversights or conflicts between existing requirements of Standards.

63. All other narrow-scope standard-setting undertaken is in the form of a narrow-scope amendment to a Standard.

Staff analysis

64. If the Committee agrees with the staff recommendations earlier in this paper, it would propose to specify that the 'cost of fulfilling' a contract in IAS 37 includes both the incremental costs of fulfilling the contract and other costs that relate directly to the contract. The Committee would also provide examples of costs that do and do not relate directly to a contract to provide goods or services.

65. In favour of amending IAS 37 instead of issuing an interpretation, it could be argued that:

    (a) the proposals in paragraph 64 would add new requirements to IAS 37 that would apply to all onerous contracts rather than clarify how existing requirements should apply to particular types of onerous contracts.

    (b) these new requirements could amount to no more than a few sentences of additional text. In which case, they could easily be inserted into IAS 37, without disrupting the structure of the Standard. The requirements would be more apparent and accessible to readers of IAS 37 if included within the body of the Standard instead of in a separate Interpretation.

66. We think that the proposed changes recommended in this paper would be too significant to be made as part of the annual improvements process. Diverse views on the meaning of the term 'cost of fulfilling' mean that any amendments would do more than clarify 'wording' or correct a minor unintended consequence, oversight or conflict. The new requirements could have a significant effect on the costs entities consider in assessing whether a contract is onerous.

Staff recommendation

67. For the reasons in paragraphs 64–66, the staff recommend that the Committee should develop its proposals as separate narrow-scope amendments to IAS 37.

Question 4 for the Committee
Does the Committee agree that is should develop its proposals as separate narrow-scope amendments to IAS 37?

Appendix—Requirements of other IFRS Standards

A1. This appendix contains a table outlining the costs an entity is required to include and exclude when measuring assets in other IFRS Standards.

IFRS Standard	Costs included	Costs excluded
IFRS 15	Paragraphs 95–97 of IFRS 15 addresses costs incurred in fulfilling a contract. It states that, if those costs are not within the scope of another IFRS Standard, they should be recognised as an asset only if, among other things, they relate directly to a contract or to an anticipated contract that the entity can specifically identify. IFRS 15 goes on to specify that costs that relate directly to a contract include:	Paragraph 98 identifies costs that would not be recognised as assets and would instead be recognised as expenses when incurred: (a) general and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity shall evaluate those costs in accordance with paragraph 97); (b) costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract;

	(a) direct labour (for example, salaries and wages of employees who provide the promised services directly to the customer); (b) direct materials (for example, supplies used in providing the promised services to a customer); (c) allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance and depreciation of tools, equipment and right-of-use assets used in fulfilling the contract); (d) costs that are explicitly chargeable to the customer under the contract; and (e) other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).	(c) costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (ie costs that relate to past performance); and (d) costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

IFRS 17	Paragraph B65 says cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include: … (f) claim handling costs (ie the costs the entity will incur in investigating, processing and resolving claims under existing insurance contracts, including legal and loss-adjusters' fees and internal costs of investigating claims and processing claim payments). (g) costs the entity will incur in providing contractual benefits paid in kind. (h) policy administration and maintenance costs, such as costs of premium billing and handling	Paragraph B66 lists cash flows that shall not be included when estimating the cash flows that will arise as the entity fulfils an existing insurance contract: … (e) cash flows that arise from abnormal amounts of wasted labour or other resources that are used to fulfil the contract. Such costs are recognised in profit or loss when incurred. (f) income tax payments and receipts the insurer does not pay or receive in a fiduciary capacity. Such payments and receipts are recognised, measured and presented separately applying IAS 12 Income Taxes. (g) cash flows between different components of the reporting entity, such as policyholder funds and shareholder funds, if those cash flows do not change the amount that will be paid to the policyholders. …

	policy changes (for example, conversions and reinstatements). Such costs also include recurring commissions that are expected to be paid to intermediaries if a particular policyholder continues to pay the premiums within the boundary of the insurance contract. (i) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis. … (l) an allocation of fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent, and maintenance and utilities) directly attributable to fulfilling insurance contracts.	

	Such overheads are allocated to groups of contracts using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics. (m) any other costs specifically chargeable to the policyholder under the terms of the contract.	
IAS 2	Paragraph 10 states that the cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. The costs of purchase are defined in paragraph 11 as comprising the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services.	Paragraph 16 identifies costs that would be excluded from the cost of inventory. They are: a) abnormal amounts of wasted materials, labour or other production costs; b) storage costs, unless those costs are necessary in the production process before a further production stage; c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and d) selling costs.

	Costs of conversion are defined in paragraph 12 to include costs directly related to the units of production, such as direct labour, and a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings, equipment and right-of-use assets used in the production process, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.'	

IAS 16	Paragraph 16 states that the cost of an item of property, plant and equipment comprises: (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates. (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.	Paragraph 19 provides examples of costs that are not included in the cost of an item of property, plant and equipment: (a) costs of opening a new facility; (b) costs of introducing a new product or service (including costs of advertising and promotional activities); (c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and (d) administration and other general overhead costs.

	Examples of directly attributable costs are provided in paragraph 17: (a) costs of employee benefits (as defined in IAS 19 *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment; (b) costs of site preparation; (c) initial delivery and handling costs; (d) installation and assembly costs; (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and (f) professional fees.	
IAS 38	IAS 38 distinguishes between acquired and internally generated intangible assets.	<u>Separately acquired intangible assets</u>

	Separately acquired intangible assets Paragraphs 27 states that the cost of a separately acquired intangible asset comprises: (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and (b) any directly attributable cost of preparing the asset for its intended use. Paragraph 28 states that examples of directly attributable costs are: (a) costs of employee benefits (as defined in IAS 19) arising directly from bringing the asset to its working condition; (b) professional fees arising directly from bringing the asset to its working condition; and (c) costs of testing whether the asset is functioning properly. Internally generated intangible assets	Paragraph 29 states that examples of expenditures that are not part of the cost of an intangible asset are: (a) costs of introducing a new product or service (including costs of advertising and promotional activities); (b) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and (c) administration and other general overhead costs. Internally generated intangible assets Paragraph 67 states that the following are not components of the cost of an internally generated intangible asset: (a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;

	Paragraph 66 defines the cost of an internally generated intangible asset as comprising all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management. Examples of directly attributable costs are: (a) costs of materials and services used or consumed in generating the intangible asset; (b) costs of employee benefits (as defined in IAS 19) arising from the generation of the intangible asset; (c) fees to register a legal right; and (d) amortisation of patents and licences that are used to generate the intangible asset.	(b) identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and (c) expenditure on training staff to operate the asset.
IAS 40	Paragraph 21 states that the cost of a purchased investment property comprises its purchase price and any directly attributable expenditure. Directly attributable expenditure includes, for example,	Paragraph 23 states that the cost of an investment property is not increased by: (a) start-up costs (unless they are necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management),

	professional fees for legal services, property transfer taxes and other transaction costs.	(b) operating losses incurred before the investment property achieves the planned level of occupancy, or (c) abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.