

## STAFF PAPER

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## IASB® Meeting

<b>Project</b>	<b>Onerous Contracts—Cost of Fulfilling a Contract (Proposed amendments to IAS 37)</b>		
<b>Paper topic</b>	Examples of costs that do, and do not, relate directly to a contract		
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**Introduction and purpose**

1. The [Exposure Draft](#) *Onerous Contracts—Cost of Fulfilling a Contract* (Exposure Draft) contained proposals to make a narrow-scope amendment to IAS 37 to clarify which costs an entity includes in determining the ‘cost of fulfilling’ a contract for the purpose of assessing whether that contract is onerous. The Board proposed to clarify that such costs comprise those that relate directly to the contract. It also proposed to add to IAS 37 examples of costs that do, and do not, relate directly to a contract.
2. The invitation to comment on the Exposure Draft invited respondents to comment on those examples. This paper discusses the comments received.
3. This paper includes:
  - (a) background information (paragraphs 4–6)
  - (b) feedback overview (paragraphs 7–20);
  - (c) staff analysis (paragraphs 21–27); and
  - (d) staff conclusion and recommendation (paragraphs 28–29).

**Background Information**

4. In paragraph BC25 of the Exposure Draft the Board noted that several IFRS Standards specify the types of costs to include in the measure of a non-monetary asset. These Standards require an entity to include both the incremental costs of purchasing or constructing an asset and any other directly related or directly attributable costs. The

Board listed as examples IFRS 15 *Revenue from Contracts with Customers*, IAS 2 *Inventories*, IAS 38 *Intangible Assets* and IAS 40 *Investment Properties*.

5. After considering the terminology in the Standards listed in paragraph BC25, the Board decided to propose the phrase ‘that relate directly’, which matches the phrase used in IFRS 15.
6. The Exposure Draft proposed adding paragraphs 68A and 68B to IAS 37 to provide examples of costs that do, and do not, relate directly to a contract. The proposed examples are based on those listed in paragraphs 97–98 of IFRS 15. The proposed paragraphs stated:

68A Examples of costs that relate directly to a contract to provide goods or services include:

- (a) direct labour (for example, salaries and wages of employees who manufacture and deliver the goods or provide the services directly to the counterparty);
- (b) direct materials (for example, supplies used in fulfilling the contract);
- (c) allocations of costs that relate directly 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 explicitly chargeable to the counterparty under the contract; and
- (e) other costs incurred only because an entity entered into the contract (for example, payments to subcontractors).

68B General and administrative costs do not relate directly to a contract unless they are explicitly chargeable to the counterparty under the contract.

## Feedback

7. Many respondents agreed with the Board’s proposal to include examples of costs that do, and do not, relate directly to a contract. However, many respondents had questions, or expressed concerns, about how those examples were expressed in the Exposure Draft.

### ***Principle underpinning the examples***

8. Some respondents suggested that the Board include in IAS 37 the principle that underpins the proposed examples. For example, an accounting firm suggested that the Board could include in IAS 37 the wording of paragraph BC16(b) of the Exposure Draft. Paragraph BC16(b) says ‘the directly related cost approach—includes all the costs an entity cannot avoid because it has the contract. Such costs include both the incremental costs of the contract and an allocation of other costs incurred on activities required to fulfil the contract.’

### ***Examples in proposed paragraph 68A / requirements in other Standards***

9. Several respondents commented on the similarities and differences between the ‘directly related’ costs that would be specified by IAS 37 and the ‘directly related’ or ‘directly attributable’ costs specified by the other Standards listed in paragraph BC25:
- (a) Production costs/fixed and variable overheads—A few respondents suggested basing the examples on those in IAS 2 relating to the cost of inventories, rather than those in paragraphs 97–98 of IFRS 15. They noted that IAS 2 refers to fixed and variable production overheads and indirect costs of production. Others asked for clarity about whether to include an allocation of production overheads. An accountancy body noted that paragraph B65 of IFRS 17 requires an entity to include an allocation of fixed and variable overheads directly attributable to fulfilling insurance contracts that include ‘...the costs of accounting, human resources, information technology and support, building depreciation, rent, and maintenance and utilities.’ It asked for clarity in this respect because proposed paragraph 68B states that general and administrative costs do not

relate directly to a contract (see paragraphs 14–16 of this paper for further discussion of general and administrative costs).

- (b) Salaries and wages of employees—A few respondents noted that proposed paragraph 68A(a) refers to ‘salaries and wages of employees’ but paragraph 17(a) of IAS 16 describes similar costs as ‘costs of employee benefits (as defined in IAS 19 *Employee Benefits*)’. Those respondents asked whether the difference is intentional and implies some costs (for example pension costs) should not be considered applying the proposed amendments.
  - (c) Abnormal amounts of wasted materials—A few respondents noted that IFRS 15, IAS 2 and IAS 16 prohibit entities from including in the measure of an asset costs of wasted materials, labour or other resources. Those respondents said the Exposure Draft does not mention such costs and, accordingly, it is not clear whether an entity excludes costs of wasted materials, labour or other resources from its assessment of whether a contract is onerous.
10. A few respondents asked for clarification of whether the costs entities would be required to include differ from those previously required by IAS 11 *Construction Contracts*. IAS 11, for example, prohibited the inclusion of selling costs but required entities to include borrowing costs if those borrowing costs are attributable to contract activity in general and can be allocated to the contract.
  11. An accounting firm suggested removing any reference to IAS 16 and IAS 38 from the Basis for Conclusions. It explained that, in its view, IAS 16 and IAS 38 have a different concept of ‘directly attributable’ costs from that in IAS 2, and that IAS 2’s requirements (which require entities to include the allocation of production overheads) more directly link to the Board’s proposals.
  12. Another accounting firm suggested that the explanation in paragraph BC26 should be included in the Standard to better convey the Board’s intentions. Paragraph BC26 says ‘the Board concluded that, ideally, the way an entity determines the cost of fulfilling a contract to deliver goods should be consistent with the way in which it determines 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.’

13. Some respondents recommended that the Board undertake a project (separate from this narrow-scope amendment) to harmonise the wording used to describe costs across the Standards listed in paragraph 4. One national standard-setter went further, saying ‘we believe that the [Board] should undertake further research into the notion of costs and the role they should play in financial reporting. This could be linked with an exploration of the conceptual basis for historical cost accounting.’

***Proposed paragraph 68B: general and administrative costs***

14. Many respondents suggested clarifying the treatment of general and administrative costs to better distinguish between costs that relate directly to a contract and general costs of operating a business. In particular, those respondents asked about the interaction between proposed paragraphs 68A(c), 68A(e) and 68B. For example, a group representing preparers said an entity may set up a subsidiary to fulfil a contract and it is unclear whether any general and administrative costs of operating that subsidiary would relate directly to the contract. It went on to say:

It would therefore be helpful to include in paragraph 68B an additional proviso that general or administrative costs do not ordinarily relate directly to a contract unless it can be demonstrated that they are directly related.

15. Some respondents said general and administrative costs should never be included in the cost of fulfilling a contract, even if the costs are explicitly chargeable to the counterparty under the contract. For example, a manufacturing entity said:

It is our opinion that [proposed paragraph 68B] may lead to an unnecessary diversity in practice because provisions can be influenced by the “mode” of recharging costs (implicitly or explicitly). Thus, general administration costs should not, independent from their rechargeability, be part of the provision for anticipated losses in onerous contracts. For costs mentioned in IFRS 15.98 (b) we deem their inclusion questionable.

16. Other respondents suggested that the Board include more examples of costs that do not relate directly to a contract.

**Other requests relating to proposed paragraphs 68A and 68B**

17. Some respondents noted that proposed paragraph 68A includes examples only for contracts to provide goods or services. They suggested it would be helpful to have examples of costs that relate directly to other types of contracts, the most common type suggested being purchase contracts.
18. In contrast, an accounting firm said it is ‘not sure that adding other examples illustrating the costs to be included in the onerous contract assessment for non-IFRS 15 contracts would add clarity to the standard’.
19. A national standard-setter suggested including requirements on *how* an entity allocates costs that relate directly to contract activities for several contracts. It suggested clarifying whether an entity allocates costs based on historical normal capacity or expected future projects/unit of production.
20. Some respondents suggested clarifying whether the costs listed in proposed paragraphs 68A and 68B are examples or an exhaustive list.

**Staff Analysis**

21. Any wider scope project to align the wording describing costs across IFRS Standards is beyond the scope of this project. That suggestion is not considered further in this analysis.
22. Respondents generally supported the Board’s proposal to clarify which costs relate directly to a contract. The comments received indicate there are two ways the Board could provide that clarification:
  - (a) through examples (as proposed in the Exposure Draft), considering whether and if so how to expand or improve the list of examples proposed in the Exposure Draft (see paragraphs 23–24); or
  - (b) by replacing or reinforcing the examples with a description of the two types of costs that relate directly to a contract (see paragraphs 25–27).

### *Examples*

23. It could be argued that the Board should confirm the Exposure Draft proposals to provide clarification through examples:
- (a) as noted in paragraph 7, many respondents agreed with the Board’s proposal to illustrate its proposed requirements with examples.
  - (b) the examples proposed in the Exposure Draft are helpful to stakeholders because they are consistent with the examples in IFRS 15 and focus on the types of contracts for which requirements are most needed—questions about what costs an entity includes in assessing whether a contract is onerous typically arise for contracts to provide goods or services (rather than purchase contracts).
24. However, the feedback described in paragraphs 8–20 of this paper suggests that, if the Board provides clarification through examples, it may need to reconsider the examples it decides to include. In particular, the Board would need to consider:
- (a) whether to continue to base the examples on those in IFRS 15. A few respondents suggested that IAS 2 may provide a better basis for examples. The Board would need to consider this suggestion and explain why the examples it has chosen provide a better illustration than those in other IFRS Standards.
  - (b) whether to include examples of costs for other types of contract, such as purchase contracts.
  - (c) whether general and administrative costs should be included in the assessment of whether a contract is onerous if those costs are explicitly chargeable to the counterparty.

### *Replace or reinforce examples with descriptions of the two types of costs*

25. Instead of providing only examples, the Board could pick up a suggestion from one respondent (see paragraph 8). It could add to IAS 37 a broader description of the two types of costs that relate directly to a contract—that is, the incremental costs of that contract and an allocation of other costs that relate directly to contract activities.

26. Adopting such requirements would not necessarily require the Board to have no examples in IAS 37. The Board could illustrate each type of cost with an example. By way of illustration, paragraph 68A of the Exposure Draft could be redrafted to something like:

68A The costs that relate directly to a contract consist of both:

- a) the incremental costs of fulfilling that contract—for example direct labour and materials; and
- b) an allocation of costs that relate directly to fulfilling that and other contracts—for example an allocation of depreciation on an item of property, plant and equipment used in fulfilling the contract.

27. There are several benefits to replacing or reinforcing the examples with a description the two types of costs that relate directly to a contract:

- (a) the requirements would apply to all types of contract. This would avoid the need to specify examples for different types of contracts, including contracts to provide goods or services and contracts to purchase goods or services. The Board would therefore address concerns that the Exposure Draft focuses on one specific type of contract.
- (b) focusing on the principles rather than individual types of costs could also avoid confusion over differences in the wording of examples in different IFRS Standards. Instead of basing examples on one existing IFRS Standard, the Board would articulate the principle that underpins the examples of costs in each of those Standards.
- (c) describing the characteristics of the costs to include would provide a framework within which an entity can apply judgement to determine whether to include or exclude a particular cost. It would be clear that any examples included in the requirements are intended to be examples only. There would be less risk of preparers including or excluding costs simply because those costs were either included in, or omitted from, a list.



**Staff conclusion and recommendation**

28. For the reasons described in paragraphs 25–27, we recommend that the Board replace the examples proposed in the Exposure Draft with a clarification that the costs that relate directly to the contract consist of:
- (a) the incremental costs of fulfilling that contract, and
  - (b) an allocation of costs that relate directly to fulfilling that and other contracts.

The clarification could be drafted using wording like that illustrated in paragraph 26.

29. If the Board disagrees with the staff recommendation and would prefer the requirements to take the form of examples (as proposed in the Exposure Draft), we will prepare for a future Board meeting a paper discussing whether and how to amend the examples proposed.

**Question for the Board**

Does the Board agree with the staff recommendation described in paragraph 28 of this paper?