3. Onerous contracts

This article aims to:
Explain the elements of cost that are considered unavoidable while accounting for onerous contracts.

Under Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*, an 'onerous contract' is one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under the contract. It is important to note that a contract on unfavourable terms is not necessarily onerous. In certain cases, a contract may not be performing as well as anticipated. In those cases such contracts may not be onerous unless the costs of fulfilling the obligations under the contract exceed the benefits to be derived.

Recently, the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India issued its opinion[1] on 'Accounting for provision to be created for onerous contract'.

Accounting under Ind AS

In assessing whether a contract is onerous, it is necessary to consider:

- The unavoidable costs of meeting the contractual obligations, which is the lower of the net costs of fulfilling the contract and the cost of terminating it; and
- The economic benefits expected to be received.

In determining the costs of fulfilling a contract, an entity considers the payments due in the period in which the contract cannot be cancelled. If there is an option to cancel the contract and pay a penalty, then the entity also considers the present value of the amount to be paid on cancellation of the contract, and measures the contract at the lowest net cost to exit.

Unavoidable costs of meeting the contractual obligations

Only unavoidable costs directly associated with meeting the entity's obligations to deliver the goods or services under the contract should be considered in determining whether the contract is onerous and in measuring any resulting provision. Accordingly, the unavoidable costs of meeting the obligations under the contract are only costs that:

- Are directly variable with the contract and therefore, incremental to the performance of the contract
- Do not include allocated or shared costs that will be incurred regardless of whether the entity fulfils the contract; and
- Cannot be avoided by the entity's future actions.

The issue raised to the EAC relates to elements of costs to be considered while recognition of provision in respect of onerous contract.

In EAC's opinion the expression 'unavoidable costs' means the costs that cannot be avoided due to existence of a contract. These are the costs that directly relate to the contract for example:

- Direct labour
- Direct material
- Allocations of costs that relate directly to contract activities, etc.

The querist in this case had not considered administrative overheads, finance charges, research and development expenses, sales overhead and head quarter expenditure while creating provision for onerous contract. The EAC is of the view that generally such costs do not relate directly to a contract and therefore, should not be considered while creating provision for the onerous contract.

It pointed out that since Ind AS 37 requires to provide for all the costs to fulfil the obligations under the contract, the Committee is of the view that in a contract to supply a product, the costs should include all costs till supply of the product including the cost of supplying the product.

Cost of terminating a contract

The EAC also pointed out that as per the requirements of Ind AS 37, any compensation or penalties arising from failure to fulfil the onerous contract is to be compared with the cost of fulfilling such contract to determine the least net cost of exiting from the contract.

In the given case, it was highlighted that it would be difficult for the querist to determine the compensation/penalty payable for failure to fulfil the contract. However, the EAC pointed that the same should be determined/estimated on a reasonable basis considering the contract terms so as to determine whether the contract is onerous or not and in case the contract is onerous, to determine the amount of provision to be provided for such onerous contract.

Considerations

- Assessment of an onerous contract should be made based on the contract as a whole rather than on an item-by-item basis or on a performance obligation-by-performance obligation basis.
- If a contract can be terminated without incurring a penalty, then it is not onerous.
- Before a separate provision for an onerous contract is recognised, an entity recognises any impairment loss that has occurred on assets dedicated to the contract.

1. The ICAI Journal, June 2019