Accounting for provision to be created for onerous contract

A. Facts of the Case

1. The querist has sought the opinion of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) on accounting treatment of expenditure relating to onerous contract. Indian Accounting Standard (Ind AS) 37, 'Provisions, Contingent Liabilities and Contingent Assets' 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". Further, as per Ind AS 37, "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 fulfill it." According to the querist, 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 or not; and
    - cannot be avoided by the entity's future actions.
2. An order for supply of 57 Nos. of 60 T dumpers was received from the customer, against which, the quantity was increased to 90 Nos., subsequently. The unit price of the equipment is ₹ 190.00 lakh. 64 Nos. equipments were supplied during the year 2017-18 and balance quantity remaining to be supplied is 26 Nos. as on 31.03.2018, which as per the querist, is an onerous contract. 5 Nos. of the equipment are in finished stock as on 31.03.2018, the value of which has been derated to the sale price value.

    Observation raised by Resident Audit Party of Comptroller and Auditor General (CAG)
3. From the details of cost of production and cost of sales (approx.), it is seen that the cost of fulfilling the contract exceeds the economic benefits expected to be received from it. Hence, the contract is onerous and provision towards the same needs to be made as per Ind AS 37 (Provisions, Contingent Liabilities and Contingent Assets).

    Ind AS 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. 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 fulfill it.

    The company has made a provision only to the extent of cost of production incurred, but the provision has to be made with reference to cost of sales, as the cost of fulfilling the obligations under the contract will include all the costs that will be incurred upto the point of sale.

    To complete the production and supply the equipments under the contract, the company has to incur further expenditure which may be fixed or variable cost. Irrespective of the nature of the cost, further costs are not avoidable and are to be provided for under onerous contract.

    Management Reply:
4. The management reply to CAG is as follows:

    Ind AS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligation under the contract exceeds the economic benefits expected to be received under the contract. The unavoidable costs under a contract reflect the least net cost of exiting from the contract by way of compensation or penalties.

    As per the terms of the contract, if contractor failed to supply, the customer can purchase the equipment at the risk and cost of the defaulting supplier with forfeiture of security deposit as applicable. As the subject contract is ongoing contract, such exiting cost cannot be measured. As audit confirmed, the company has already made provision, considering selling price or cost of production whichever is lower for valuation of inventory.

Hence, cost upto cost of production has already been considered for valuation, which is directly variable with the contract and therefore incremental to the performance of the contract.

Unavoidable cost does not include allocated share of cost that will be incurred regardless of whether the entity fulfills the contract or not.

Moreover, other expenditure like administrative overheads, R&D, finance charges, head quarter expenditure, sales overheads etc., are of the nature of period cost and the purpose of these expenditure related to the said sales order is already completed in 2017-18 itself with receipt of sale order.

Hence, there is no non-compliance of Ind AS 37.

5. The querist has further submitted the following for consideration of the Expert Advisory Committee before issue of an expert opinion:

(i) The following are the details of costs that have been considered for creation of provision towards onerous contract:

a) Material cost – includes cost of material procured, cost of freight & insurance incurred for material procurement and handling, loading and unloading charges incurred.

b) Labour cost/ Factory Overheads – includes salaries and other expenses of direct production department; and also expenses allocated from indirect departments to direct department.

c) Material Overheads – Includes salaries and other expenses (including expenses allocated from other departments) booked under departments linked with materials like purchases, stores and quality control.

(ii) In the above referred query of CAG also, the provision has been made considering the above costs only. For example, the value of provision created for a quantity of 21 Nos. remaining to be produced is as per following working shown :

Particulars	Value (₹ in lakhs)
Cost of production (which includes material cost, labour cost/factory overhead and material overhead)	199.00
Selling Price	190.00
Differential cost	9.00
No. of equipment remaining to be produced	21
Value of provision created	189.00

Costs incurred towards administrative overheads, finance charges, R & D expenses, sales overhead, head quarter expenditure etc., are considered as period cost and hence not considered for creation of provision.

B. Query

6. In view of the facts explained above, opinion of the Expert Advisory Committee has been sought on the following issues:

(i) Whether the company's accounting treatment of cost considered by the company for creation of provision towards onerous contracts is in line with the provisions of Ind AS 37.

(ii) If no, what are the additional costs that the company has to consider while calculating the value of provision to be created towards onerous contract?

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to elements of costs to be considered while recognition of provision in respect of onerous contract under Ind AS 37. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, determination of whether the contract in the extant case is onerous or not, timing or amount of revenue recognition, recognition of impairment loss on assets dedicated to onerous contract, etc. Further, the Committee while expressing its opinion has laid down the principles to be followed while making the provision for the onerous contract and has not determined or calculated the actual amount to be provided for. Incidentally, the Committee notes from the Facts of the Case

that the company has certain equipments lying in finished stock, which have been apparently measured (derated) to sale price value. In this context, the Committee wishes to point out that as per the requirements of Ind AS 2, 'Inventories', inventories should be measured at the lower of cost and net realisable value, which may not be necessarily equal to sale price value. Ind AS 2 defines 'net realisable value' as the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

8. The Committee notes the following requirements of Indian Accounting Standard (Ind AS) 37, 'Provisions, Contingent Liabilities and Contingent Assets', notified under the Indian Accounting Standards Rules, 2015:

"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."

"66 If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.

67 Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of this Standard and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of this Standard.

68 This Standard 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. 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.

69 Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract (see Ind AS 36)."

"36 The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

37 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. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the end of the reporting period. However, the estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period."

9. At the outset, the Committee notes that the querist has stated in the Facts of the Case that as per the terms of the contract, if contractor failed to supply, the customer can purchase the equipment at the risk and cost of the defaulting supplier with forfeiture of security deposit as applicable and that as the subject contract is ongoing contract, such exiting cost cannot be measured. In this context, the Committee wishes to point out that as per the requirements of paragraph 68 of Ind AS 37, any compensation or penalties arising from failure to fulfill 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. Accordingly, although it may be difficult to determine the compensation/penalty payable for failure to fulfill the contract, 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. However, for the sake of convenience and to

answer the specific issue raised in the extant case, it is assumed that the compensation/penalty payable for failure to fulfill the contract is more than the expected cost of fulfilling/meeting the obligations under the contract.

10. The Committee notes that Ind AS 37 provides that the amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation, which 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. The Committee is of the view that in case of onerous contracts, the amount that an entity would rationally pay to settle the obligation would be the lower of the compensation or penalties arising from failure to fulfill the contract and the excess of the unavoidable costs of meeting the obligations under the contract from the economic benefits expected to be received under it. Accordingly, the provision for onerous contract should be measured on this basis. Further, the Committee is of the view that unavoidable cost of meeting the obligations under the contract should be determined in accordance with paragraph 68 of Ind AS 37.

11. With regard to the specific issue raised in the extant case relating to the costs to be considered by the company for creation of provision towards onerous contracts, the Committee notes that paragraph 68 of Ind AS 37 uses the expression 'unavoidable costs of the meeting the obligations under the contract'. The Committee is of the view that the expression 'unavoidable costs' means the costs that cannot be avoided due to existence of 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. In the context of the current issue, the Committee notes that the company has not considered administrative overheads, finance charges, R & D expenses, sales overhead and head quarter expenditure while creating provision for onerous contract. The Committee 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. Further, 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 the product, the costs should include all costs till supply of the product including the cost of supplying the product.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that the company's accounting treatment of costs considered by the company for creation of provision towards onerous contracts would be in line with the provisions of Ind AS 37 provided it is in accordance with the principles, as discussed in paragraphs 9 to 11 above.

1.	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2.	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on January 08, 2019. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3.	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty five volumes. A CD of Compendium of Opinions containing thirty five volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4.	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5.	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in. ■