Loss-making or onerous contracts

Applying IFRS® Accounting Standards

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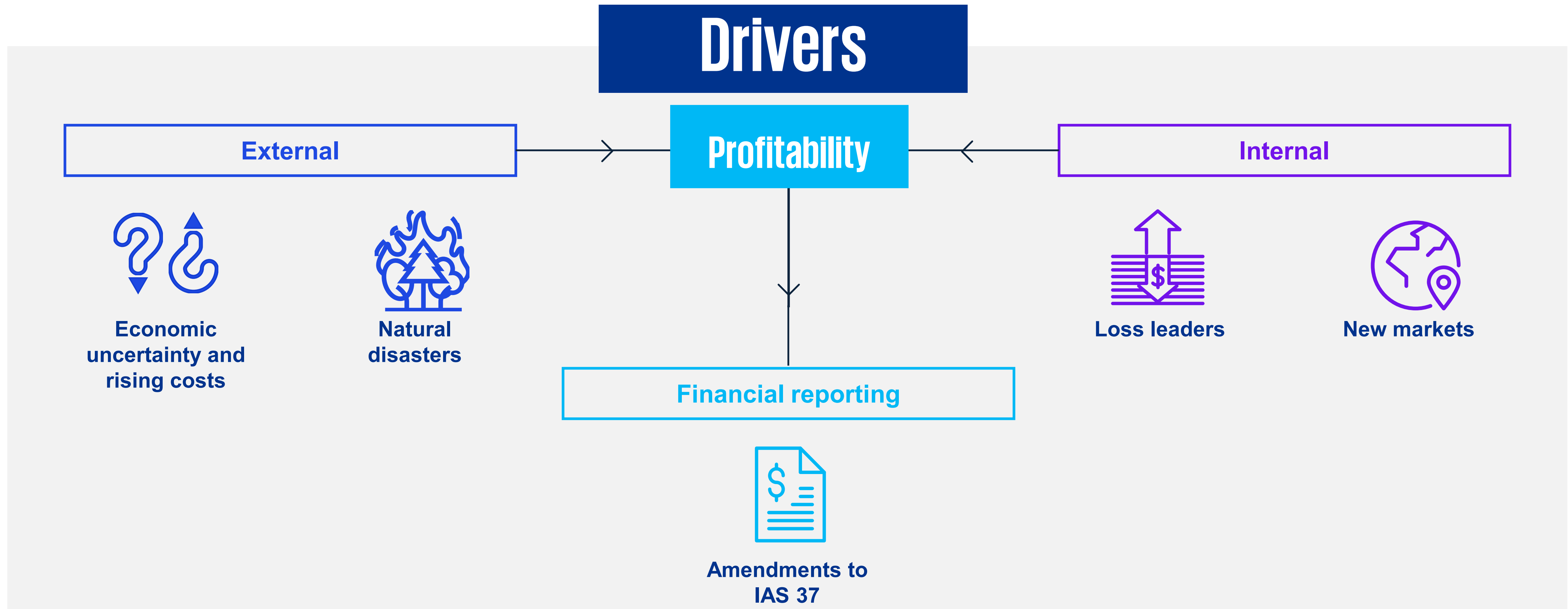
Loss-making contracts

Some contracts may be loss-making from the outset or become loss-making during their life cycle.

There may be various drivers for a loss-making contract, including external factors and a company's own strategy.



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How to account for a loss-making contract?

Our seven-step guide sets out a logical approach to accounting for loss-making contracts under IFRS® Accounting Standards.

01 What standard applies to a loss-making contract?

02 Can the contract be terminated without penalty?

03 Is the contract part of an overall loss-making operation?

04 Have you tested the related assets for recoverability?

05 What are the unavoidable costs under the contract?

06 What are the economic benefits under the contract?

07 Do the costs exceed the economic benefits?

Worked example – Putting it into practice

Visual overview – Applying IAS 37 to loss-making contracts

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01 Which standard applies to a loss-making contract?

To determine how to account for a loss-making contract, the first step is to identify the standard to apply.

Some standards provide specific guidance on the accounting for loss-making contracts – e.g. insurance contracts, financial instruments or on-balance sheet leases. If so, then **apply the specific standard**.

If **no specific standard** applies to the contract or part of it – e.g. non-lease component of a lease contract – then **apply IAS 37** *Provisions, Contingent Liabilities and Contingent Assets*.

Not all loss-making contracts are accounted for under IAS 37.

Specific standard applies

- Financial instrument
- On-balance sheet lease
- Insurance contract

Apply

- IFRS 9
- IFRS 16
- IFRS 17

No specific standard applies

- Contract with a customer for goods or services (under IFRS 15)
- Non-lease component of a lease contract

Apply

- IAS 37

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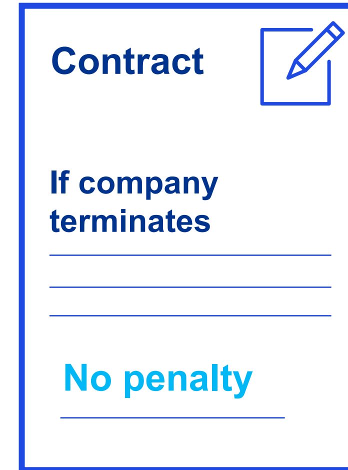
02 Can the contract be terminated without penalty?

Many contracts can be cancelled before delivery without paying a termination penalty – e.g. routine purchase orders.

Contracts that can be **terminated without penalty** are not onerous and a company makes no provision for them under IAS 37.

For contracts with a **termination penalty**, further analysis is required.



No further analysis

A contract on unfavourable terms is not necessarily onerous. Similarly, a contract that is not performing as well as anticipated, or as well as possible, may not be onerous.

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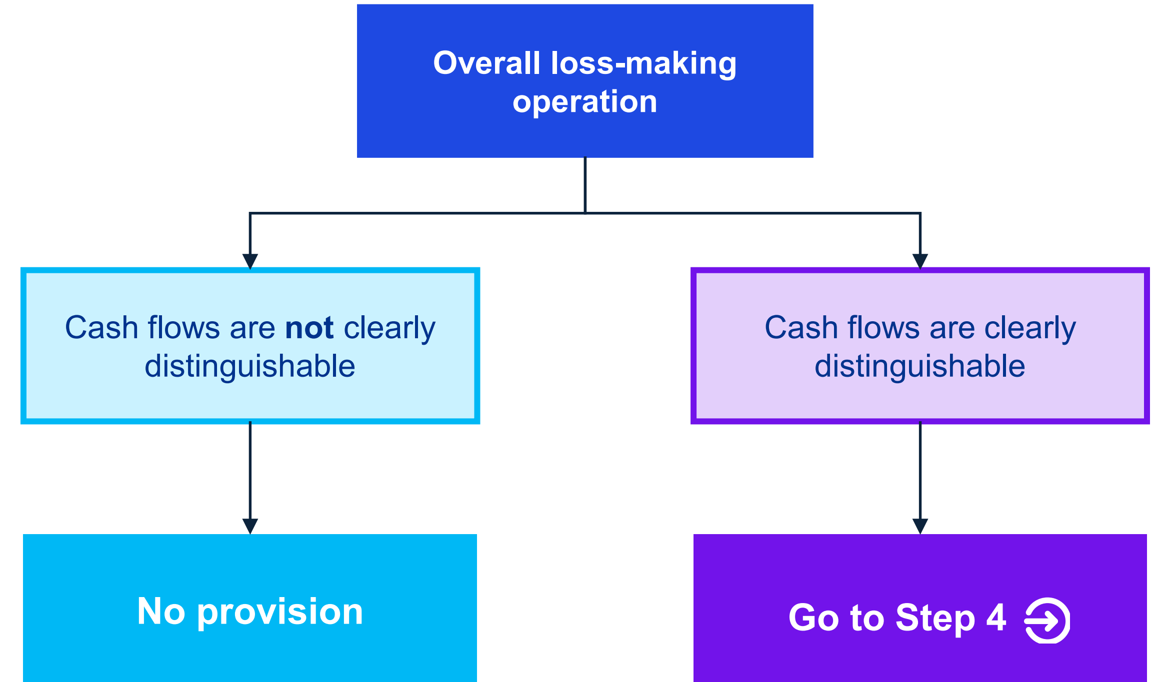
03 Is the contract part of an overall loss-making operation?

Some contracts may be part of an overall loss-making operation.

If the cash flows related to the contract are **not clearly distinguishable** from the loss-making operation as a whole, then no provision should be recognised. This is because a provision would effectively be recognised for future operating losses, which is prohibited under IFRS Accounting Standards.

If the cash flows related to the contract are **clearly distinguishable** from the loss-making operation as a whole and the contract falls in the scope of the onerous contracts requirements in IAS 37, then a company needs to test that contract to determine whether it is onerous.



Key test: Are contract cash flows clearly distinguishable from the loss-making operation as a whole?

If not, then no provision should be recognised, even if losses are forecasted.

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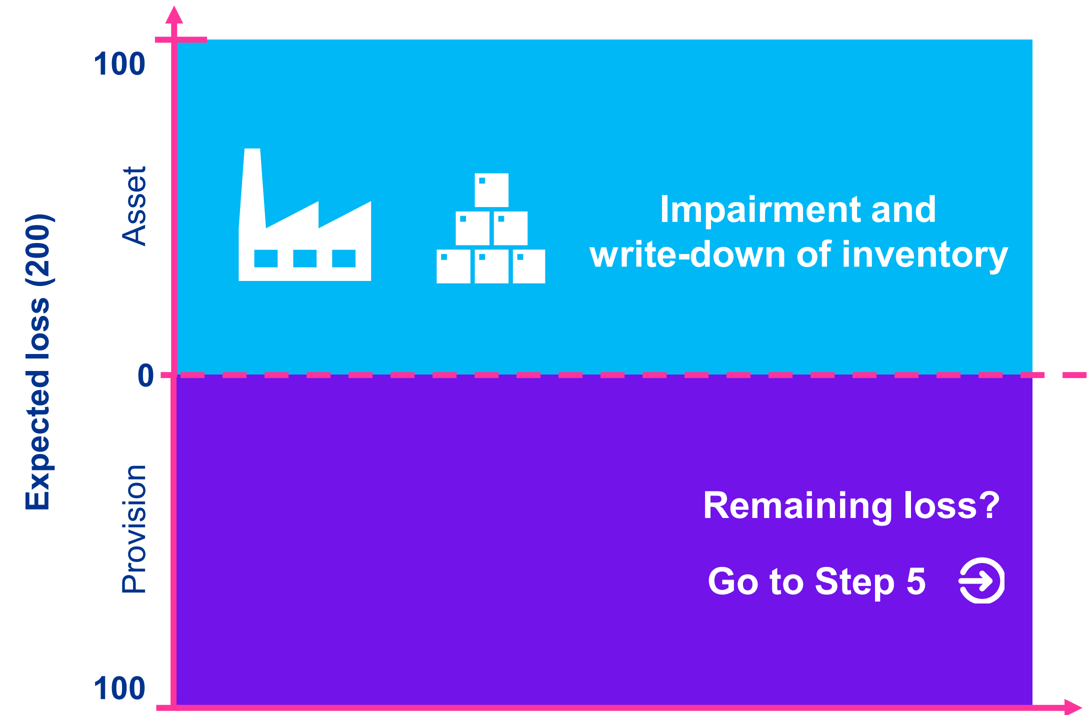
04 Have you tested the related assets for recoverability?

A loss-making contract could indicate that some assets used in fulfilling it have decreased in value – e.g. inventory or property, plant and equipment.

Before creating a separate provision for an onerous contract, companies need to test all assets used in fulfilling that contract for their recoverability and write them down, if necessary.

They need to apply IAS 36 *Impairment of Assets* to test property, plant and equipment, and IAS 2 *Inventories* to determine the net realisable value of inventory.



Test all assets used in fulfilling the contract for their recoverability before creating an onerous contract provision.

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05 What are the unavoidable costs under the contract?

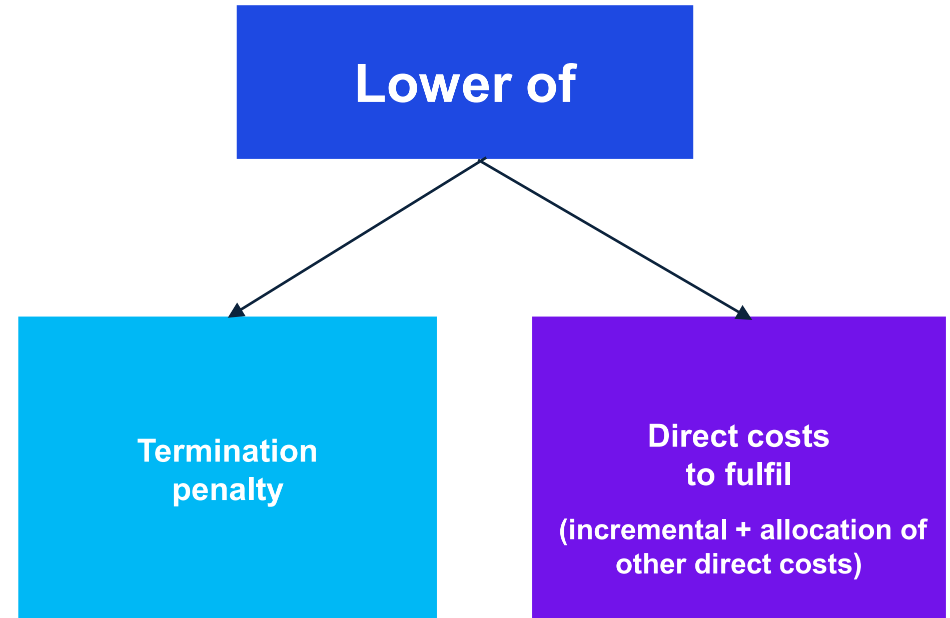
In assessing whether a contract is onerous, companies need to consider the unavoidable costs of meeting the contractual obligations.

This is the lower of:

- the direct costs of fulfilling the contract; and
- the cost of terminating it.

The **direct costs of fulfilling a contract** include:

- the **incremental costs** – e.g. direct labour and materials; and
- an **allocation of other costs** that relate directly to fulfilling the contract – e.g. an allocation of the depreciation charge for property, plant and equipment used to fulfil that contract.



The amendments to IAS 37, which are effective from 1 January 2022, clarify that the cost of fulfilling a contract for the purposes of the onerous contracts assessment comprises the costs that relate directly to the contract, including both the incremental costs and the allocation of other direct costs to fulfil the contract.

The incremental cost approach can no longer be applied.

Go to Step 6

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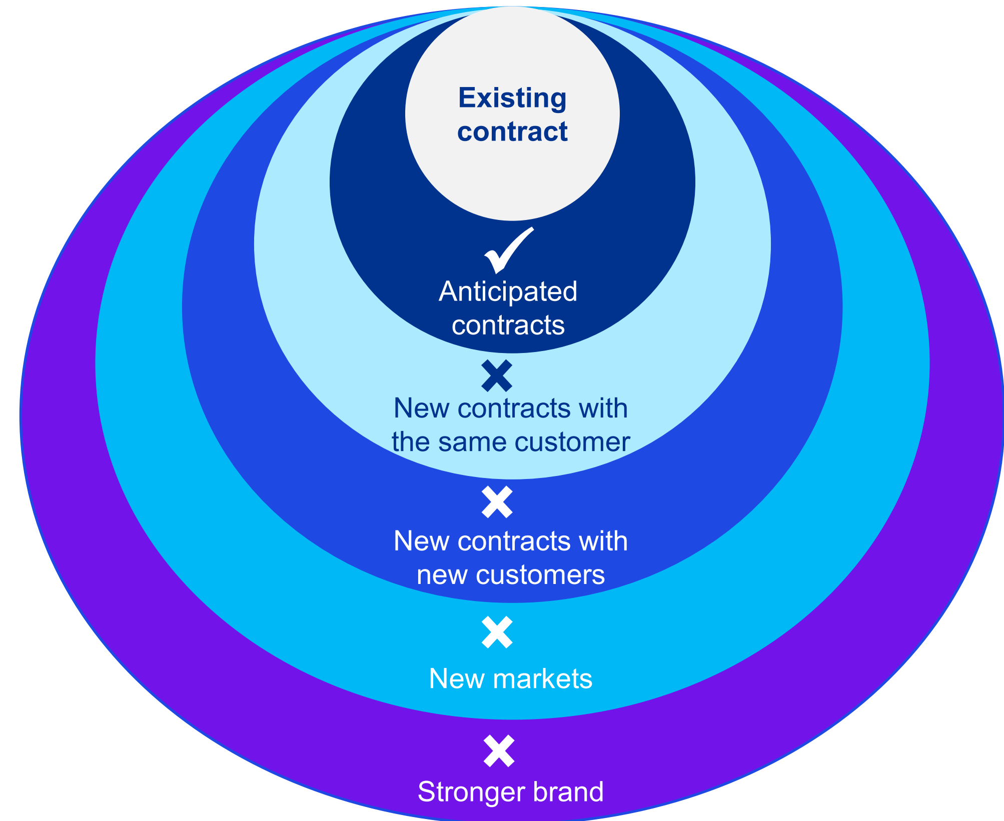
06 What are the economic benefits under the contract?

The expected benefits under a contract are the net present value of the future inflows related to the contract.

These may include future inflows from anticipated contracts with the same counterparty – e.g. under a framework agreement.

If a contract includes future inflows falling in the scope of multiple standards – e.g. revenue from contracts with customers (IFRS 15), financing income (IFRS 9) and lease income (IFRS 16) – then all inflows under the contract should be considered in assessing whether the contract is onerous.



Estimating the future benefits under the contract may require judgement, possibly based on past experience or expert advice.

Go to Step 7

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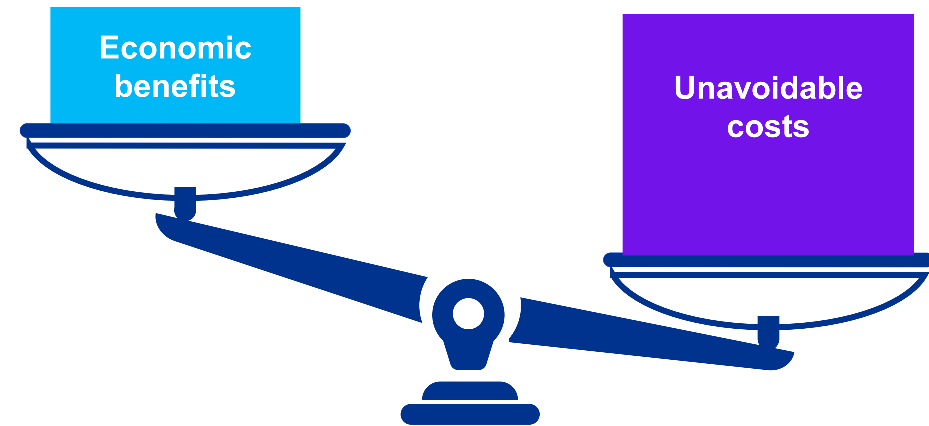
07 Do the costs exceed the economic benefits?

If the unavoidable costs of meeting the obligation under the contract (see Step 5) exceed the economic benefits expected to be received under it (see Step 6), then the contract is onerous and the company needs to recognise a provision.

Remember that before calculating a provision, any assets used in fulfilling the contract need to be written down (see Step 4).



If an onerous contract provision is necessary, then it should be measured using the same principles as those used for determining whether that contract is onerous.

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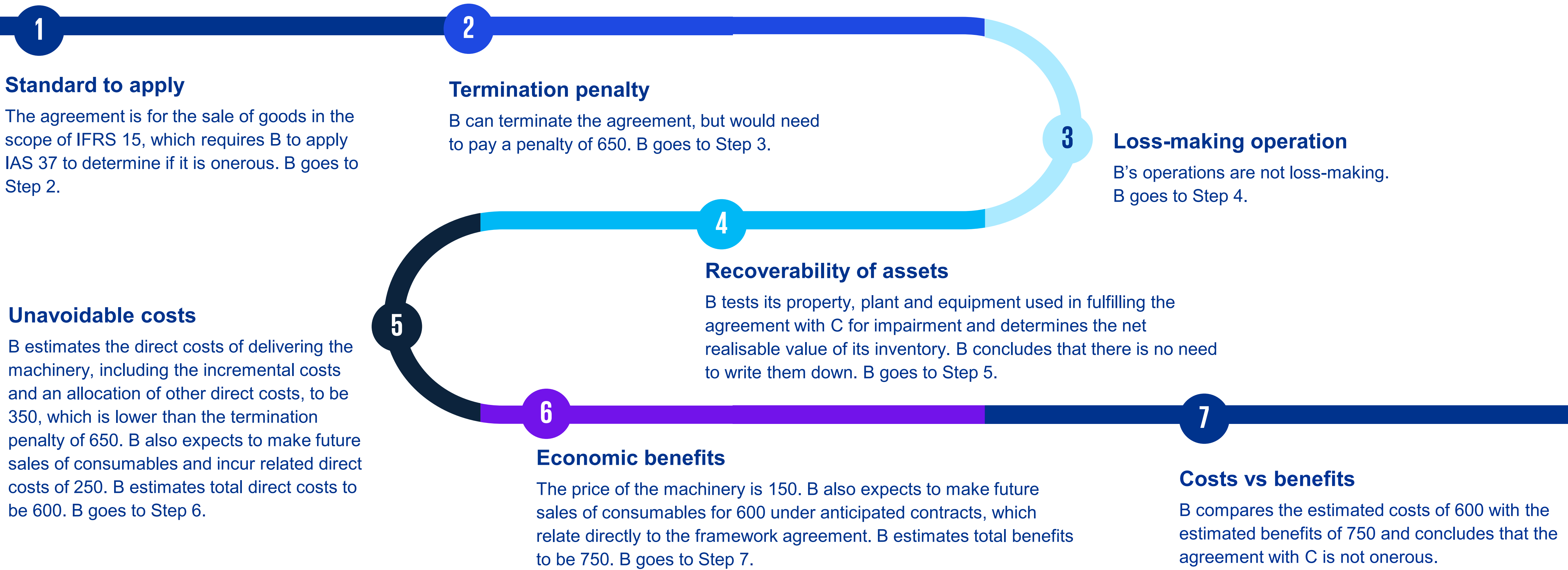
Worked example – Putting it into practice

Fact pattern

Company B is a profitable business selling machinery and consumables. B enters into a framework agreement with Customer C. Under the agreement, B will deliver an item of machinery for fixed consideration and consumables at an agreed price per unit. Although the framework agreement includes the price for consumables, C has no obligation to purchase consumables until it places an order – i.e. future purchase orders in combination with the framework agreement will create enforceable rights and obligations in respect of consumables.



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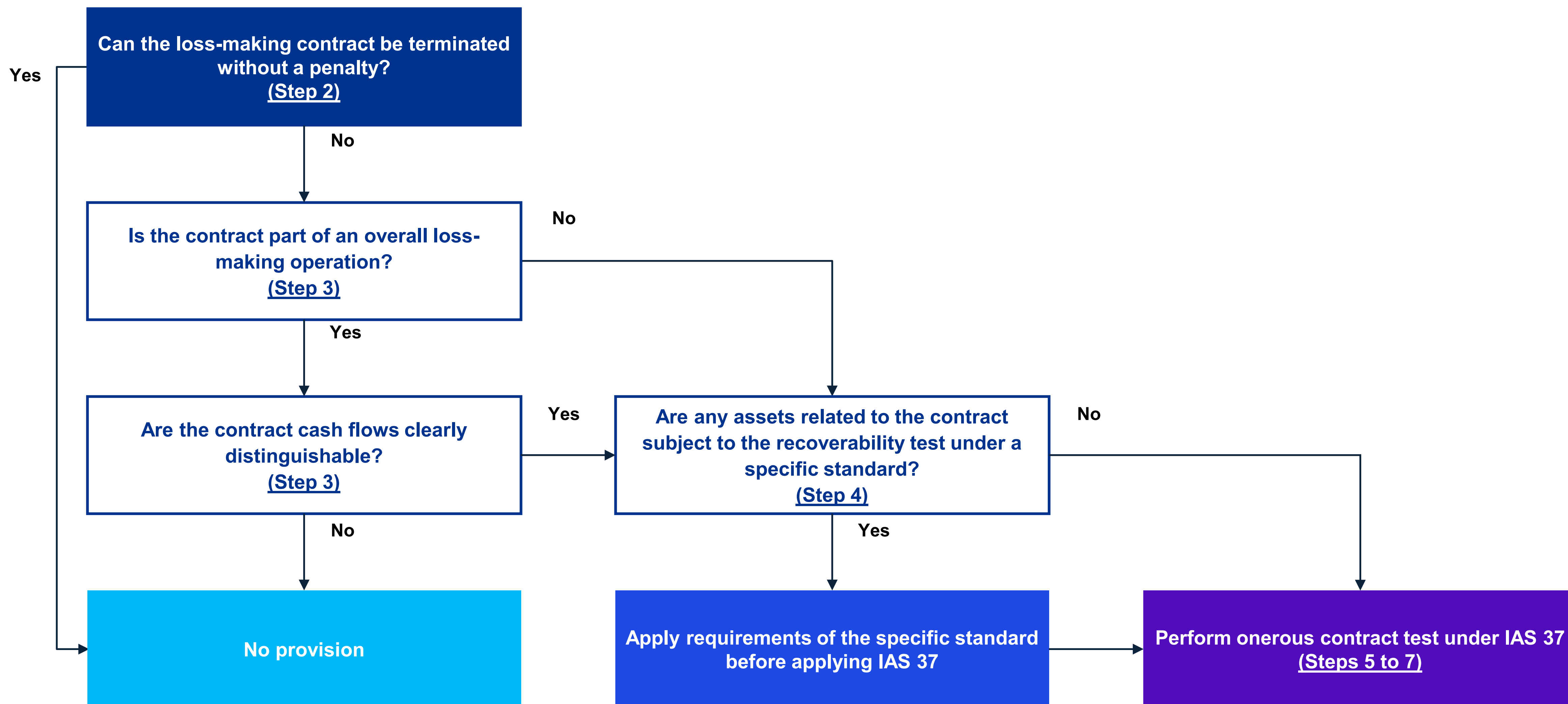
Visual overview – Applying IAS 37 to a loss-making contract



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