Accounting for Standby Costs and Penalties Incurred under a Force Majeure Clause

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A force majeure clause is generally included in a contract to relieve a party from performing its contractual obligations when an unexpected, external event occurs that prevents it from performing[1].

In the fight against COVID-19, various levels of government have imposed measures such as closing construction sites and requiring additional safety measures in many workplaces. These measures may trigger *force majeure* clauses or other similar clauses in many construction and other long-term contracts. Some contracts may allow the affected party to claim financial compensation from the non-affected party under force majeure clauses if the affected party can prove that the force majeure event has prevented it from performing its contractual obligations[2].

In a construction contract, examples of financial compensation that an affected contractor may claim from its customer include:

- payments to the contractor or supplier compensating for their employees being idle while a job site is closed;
- costs of providing additional COVID-19 protection; and
- compensation for productivity losses such as the loss in productivity when employees of the contractor or supplier work from home rather than on the job site (or are less productive on the job site because of social distancing requirements).

The Group considered the following fact pattern where a company that owns a significant asset under construction incurs standby costs and other costs to be paid to the contractor under a force majeure clause or some other similar contractual clauses. The Group discussed the accounting for these costs by the owner of the asset.

Fact Pattern

- Company A owns a major infrastructure asset under construction. The contract with the construction company, Company B, contains a *force majeure* clause that provides some relief in the event that Company B is prevented from performing construction work due to an event out of its control that cannot be avoided or mitigated (e.g. a pandemic or other global health issues such as COVID-19).

[1] Norton Rose Fulbright, "Q&A on COVID-19-related force majeure claims," Norton Rose Fulbright website, May 2020.

[2] Ibid.

- The relief includes financial compensation to be paid to Company B by Company A for additional costs incurred by Company B, such as the payment of salaries to its employees when the job site is closed, for putting in place additional safety measures for COVID-19 protection, and for productivity losses.

- Company A accounts for its asset under construction using IAS 16 *Property, Plant and Equipment*, IAS 23 *Borrowing Costs* and other related standards.

Issue 1: How should Company A account for costs under force majeure clauses or other similar contractual clauses, to be paid to Company B?

View 1A – These costs are not capitalizable and should be immediately expensed because they are abnormal costs incurred when constructing the asset.

- Proponents of this view consider the financial compensations Company A pays stems from a contractual clause that is not expected to be applied in ordinary situations. Therefore, they think these costs should be considered abnormal. Per paragraph 22 of IAS 16, "the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset." As such, they think these costs should not be capitalized.

- Proponents of this view also analogize to the guidance in paragraph 20 of IAS 23 that requires suspension of "capitalization of borrowing costs during extended periods in which it suspends active development of a qualifying asset." Furthermore, paragraph 21 of IAS 23 states that capitalization is not suspended "when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale." Given the costs incurred under the *force majeure* clauses are not due to delays as a necessary part of the process, they should not be capitalized.

View 1B – These costs can be capitalized as they are directly attributable to bringing the asset to the location and condition necessary for use.

- Proponents of this view note that paragraph 16 of IAS 16 states: "The cost of an item of property, plant and equipment comprises … 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." They note that these costs are incurred as part of the construction contract and are directly attributable to bringing the asset to the condition necessary for use. This is because if these costs are not paid, Company A may be at risk of breaching the contract, which could prevent the completion of the project.

- Proponents of this view also think the analogy to IAS 23 is inappropriate because the costs incurred under a *force majeure* clause are not incurred for holding the asset. They are incurred as part of the construction of the asset and are directly attributable to its construction.

- Therefore, these costs should be capitalized.

View 1C – Accounting for these costs will depend on facts and circumstances.

- Proponents of this view think the accounting treatment will depend on the facts and circumstances. They note that any amounts paid to a contractor for periods of time when the construction has stopped, such as during a lock-down period, should not be capitalized because they are clearly abnormal wastage that are not directly linked to the construction of the asset.
- For other costs incurred because of COVID-19, such as enhanced personal protective equipment or lower productivity due to social distancing requirements at the construction site, further analysis is needed. For example, if a contract was entered into for construction services during the pandemic, these types of costs would be embedded in the base contract price, which is capitalized as part of the cost of the asset under construction. Similarly, the proponents of this view think these types of costs should be capitalized on a contract entered into prior to the pandemic.
- In considering the facts and circumstances, proponents of this view note it is important to assess whether any costs to be capitalized are directly attributable to the construction of the asset and are not costs incurred unrelated to the actual construction of the asset.

The Group's Discussion

Most Group members preferred View 1C, noting entities should carefully assess their specific facts and circumstances to determine the accounting for these costs. Some Group members commented that incurring standby costs to contractors when the construction site is idle are examples of abnormal waste and should be expensed. On the other hand, other costs incurred to provide protection against COVID-19, such as protective equipment, or labour costs incurred due to social distancing measures may qualify for capitalization. These Group members also thought that following View 1A to treat all costs under *force majeure* clauses as abnormal may not be appropriate as the inclusion of such costs in the contract with the supplier may become more common (i.e. normal), especially as a result of the COVID-19 experience. Therefore, entities should carefully review the wording in their contracts to consider whether these costs are directly attributable to the construction of the asset. In making this assessment, these Group members noted that factors such as materiality, and the period of business interruptions should be considered.

A few Group members preferred View 1B (i.e. should be capitalized). Based on the fact pattern presented, they thought the additional costs incurred are part of the payments made to the contractor to construct the asset. Paragraph 16(a) of IAS 16 is clear that the costs of the property, plant and equipment comprises the purchase price. Therefore, these costs should be capitalized as part of the property, plant, and equipment.

Issue 2: If certain costs are capitalized, how does this impact Company A's assessment of impairment of the asset under construction?

Analysis

- Paragraph 9 of IAS 36 *Impairment of Assets*, requires Company A to "assess at the end of each reporting period whether there is any indication that an asset may be impaired." Paragraph 14 of IAS 36 provides evidence from internal reporting indicating that an asset may be impaired. This includes "cash flows for acquiring the asset, or subsequently cash needs for operating or maintaining it, that are significantly higher than those originally budgeted."
- The additional costs paid to Company B under a *force majeure* or other similar clause may be a potential indicator of impairment of the asset under construction. Company A needs to further analyze its own circumstances to determine whether these potential indicators of impairment are actual indicators of impairment warranting an impairment test in accordance with IAS 36.
- In assessing its own circumstances, Company A should consider the following factors, among others:
  - the relative amount of the additional costs to be paid to Company B;
  - the results of previous impairment tests, including the amount by which the recoverable amount exceeded the carrying value of the asset or cash-generating unit (CGU);
  - the nature, timing and impact on Company A and/or the CGU to which the asset relates, including the impact of potential delays in construction of the asset; and
  - the potential government support or insurance proceeds

The Group's Discussion

Group members agreed with the analysis. One Group member noted that this analysis is further supported by paragraph 11 of IAS 16 which states that the carrying amount of assets acquired for safety reasons should be reviewed for impairment in accordance with IAS 36. Some Group members highlighted that when considering whether potential indicators of impairment exist, entities should consider their circumstances holistically by considering all the relevant factors. Individual factors, such as the potential for government support or insurance proceeds, should not be considered in isolation when assessing whether potential impairment indicators exist.

Issue 3: When Company A receives insurance proceeds or government subsidies that are related to certain additional costs incurred and capitalized, should these proceeds and subsidies be offset against the capitalized costs?

Analysis

- When accounting for the insurance proceeds, Company A should follow paragraph 54 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The insurance proceeds should only be recognized when it is virtually certain that reimbursement will be received. When the underlying costs being reimbursed by the insurance proceeds have been capitalized, the insurance proceeds should offset against the carrying value of the asset under construction.

- When accounting for government subsidies, paragraph 24 of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* requires government grants related to assets be presented on the balance sheet either as deferred income (a liability) or a reduction of the carrying value of the asset. Subsequently, the government grant is recognized in profit or loss on a systematic basis over the periods in which Company A recognizes as expenses the related cost for which the government grants are intended to compensate.

The Group's Discussion

Group members agreed with the analysis.

One Group member noted that Company A should carefully review the insurance contract to understand whether the insurance is for business interruption. Insurance proceeds that compensate a company for loss recognized due to business interruption will be recognized generally as income in accordance with paragraph 65 of IAS 16.

Overall, the Group's discussion raises awareness on the accounting for standby costs and penalties incurred under force majeure and other similar clauses. No further action was recommended to the AcSB.