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Mr Hans Hoogervorst  
International Accounting Standards Board  
Columbus Building  
7 Westferry Circus  
London  
E14 4HD

Our ref RD/288

12 April 2019

Dear Mr Hoogervorst

**Comment Letter on Exposure Draft ED/2018/2 *Onerous Contracts – Cost of Fulfilling a Contract* (Proposed amendments to IAS 37)**

We appreciate the opportunity to comment on the International Accounting Standards Board's (the Board) Exposure Draft *Onerous Contracts – Cost of Fulfilling a Contract* (Proposed amendments to IAS 37) (ED). We have consulted with, and this letter represents the views of, the KPMG network.

We support the Board's efforts to address the long-standing diversity in practice over which costs are included in the assessment of whether a contract is onerous. With a larger population of contracts being subject to this assessment on adoption of IFRS 15 *Revenue from Contracts with Customers*, having a consistent approach to this issue is key.

For a long time, the accounting world has been divided between supporters of the 'incremental cost' approach and those favouring the 'full cost' approach. Indeed, the Board itself had challenging discussions about this topic as part of its revenue project. We acknowledge that each approach has its pros and cons. However, the immediate priority is to have a single answer and have it quickly.

If the Board is to mandate a 'full cost' approach at this time, we have a number of suggested clarifications regarding how to identify the costs that 'relate directly to the contract' and the interaction between IAS 37 and other standards – as detailed in the Appendix to this letter.

We understand that the Board has resumed its work on the Provisions research project. We recommend that as part of this project the Board revisits the guidance on future operating losses to address any inconsistency with other parts of guidance in IAS 37.



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*Comment Letter on Exposure Draft ED/2018/2 Onerous Contracts – Cost of Fulfilling a  
Contract (Proposed amendments to IAS 37)*  
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Please contact Reinhard Dotzlaw +44 (0)20 7694 8871 or Prabhakar Kalavacherla  
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Yours sincerely

*KPMG IFRG Limited*

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## Appendix

### Question 1

The Board proposes to specify in paragraph 68 of IAS 37 that the cost of fulfilling a contract comprises the costs that relate directly to the contract (rather than only the incremental costs of the contract). The reasons for the Board's decisions are explained in paragraphs BC16–BC28.

Do you agree that paragraph 68 of IAS 37 should specify that the cost of fulfilling a contract comprises the costs that relate directly to the contract? If not, why not, and what alternative do you propose?

To drive consistency of application of IFRS Standards, we support the proposal to specify what costs should be identified as the costs of fulfilling a contract. However, we believe further clarification is necessary on how to identify 'the costs that relate directly to the contract' and the interaction between the proposed amendments and the requirements in other standards.

#### *Identifying costs that relate directly to the contract*

Identifying costs that relate directly to the contract may be complex and may require judgement in some circumstances. One key challenge is to distinguish costs that relate directly to the contract from general costs of running a business, especially when analysing allocations of costs.

For example, consider a professional service firm that holds three types of insurance policies:

- insurance for a specific project undertaken under a contract with a customer;
- insurance for an office building used by the firm's staff working on this and other projects; and
- insurance for an office building that is used primarily for client meetings and corporate events.

In determining the costs of a particular project for management reporting purposes the firm includes insurance costs only for a policy specific to that project.

A question arises as to which of these types of insurance costs are the costs of fulfilling the contract with the customer. In particular, do either or both office building insurance

costs relate directly to the contract, and what test is being used to determine this. For example, is the test that the costs of fulfilling the contract are those costs that:

- are allocated to the contract for the purposes of management reporting;
- are capable of being allocated to the contract;
- are listed in paragraphs 68A–68B; or
- would be allocated to the contract in accordance with another IFRS (see the point below)?

Or is the firm free to determine its own accounting policy on this point?

*Interaction with the requirements in other standards*

Paragraphs BC24–BC25 of the ED suggest that the Board’s proposals are consistent with the requirements in other standards for measurement of non-monetary assets. This implies that an entity may refer to these other standards in order to assist it in identifying the costs of fulfilling a contract. However, while the other standards take a broadly consistent approach, there are also inconsistencies between the standards.

- **Inventories:** Under paragraph 13 of IAS 2 Inventories, costs of conversion of inventories include an allocation of fixed production overheads based on the normal capacity of the production facilities. Any abnormal costs, which are often an indication of an impaired asset or a loss-making contract – e.g. costs related to idle machinery – are expensed when they are incurred. In contrast, IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets focus on the actual costs incurred. It is not clear from the proposals whether a similar approach should be applied in determining the appropriate allocation of costs that relate directly to a contract – i.e. whether the cost estimate should be based on the normal costs of fulfilling a contract.
- **Revenue:** We understand that the list of costs included in paragraph 68B of the ED is drafted consistently with the list in paragraph 97 of IFRS 15. That guidance in IFRS 15 applies to costs that are not in the scope of, and therefore do not qualify for capitalisation under, other IFRS Standards – e.g. IAS 2, IAS 16 or IAS 38. Whereas the reference to IAS 2 could be read to suggest a limitation of the costs of fulfilling a contract to ‘normal’ costs, conversely the reference to IFRS 15 suggests the costs of fulfilling a contract would be broader than the costs eligible for capitalisation under IAS 16 or IAS 38.
- **Impairment of assets:** Under paragraph 69 of IAS 37 Provisions, Contingent Liabilities and Contingent Assets, before establishing a separate provision for an onerous contract, an entity is required to recognise any impairment loss that has occurred on assets dedicated to that contract. It is not clear whether assets ‘dedicated’ to the contract are the same assets for which an allocation of

depreciation would ‘relate directly to the contract’ and how the requirements in IAS 37 reconcile to those in IAS 36 *Impairment of Assets*.

We recommend that the Board consider the above matters and provide clarifications – e.g. in the Basis for Conclusions to the amendments, the Board may provide a steer towards IAS 2 for cost allocation challenges arising from measuring provisions for contracts to provide goods or services which have become onerous (see Question 2).

### **Question 2**

The Board proposes to add paragraphs 68A–68B which would list costs that do, and do not, relate directly to a contract.

Do you have any comments on the items listed?

Are there other examples that you think the Board should consider adding to those paragraphs? If so, please provide those examples.

We appreciate the reasons for including examples of costs that do, and do not, relate directly to the contract in the standard. However, we are concerned that these examples may be interpreted as a definitive list of costs that are always required to be included in the assessment of whether a contract is onerous, without a proper consideration of specific facts and circumstances. This may be particularly an issue with the allocation of costs. As mentioned in our response to Question 1, we believe that it is critical to distinguish the costs that relate directly to the contract from general costs of running a business and we recommend that the Board clarify how this should be done – or state that this is a judgement for preparers if that is the Board’s intention.

We also recommend that the Board amend paragraph 26 of the Basis for Conclusions to give a clear steer towards IAS 2 for cost allocation challenges arising from measuring provisions for contracts to provide goods or services which have become onerous. This clarity that IAS 2 is the most relevant reference point in applying paragraph 68A(c) would help promote consistency around treatment of operating costs.

As mentioned earlier, we understand that the list of costs included in paragraph 68B of the ED is drafted consistently with the list in the revenue standard. It is not clear if, and to what extent, that guidance should be applied to contracts in the scope of other standards – e.g. purchase contracts. We recommend that the Board clarify this.

**Question 3**

Do you have any other comments on the proposed amendments?

First, the proposed amendments focus on the onerous contract assessment and are not intended to address the measurement of onerous contracts, as mentioned in paragraphs BC13–BC14 of the ED, and we fully appreciate the Board’s arguments for taking this approach. However, it is not clear if and to what extent they should impact an entity’s existing policies for measurement of liabilities under IAS 37 other than onerous contracts. We recommend that the Board clarify this.

Second, under the proposed transitional requirements, an entity would apply the amendments to contracts *existing* at the transition date. It is not clear what the term ‘existing contracts’ is intended to cover. We note that as IFRS 15 was being developed and implemented there has been debate about the definition and boundary of a contract and the meaning of ‘completed contract’. For example, if an entity has entered into a master services agreement with a customer under which it is obliged to fulfil future orders but there are no outstanding orders at the transition date, is this an ‘existing contract’? Is the intention that an ‘existing contract’ is a contract that would not meet the definition of a ‘completed contract’ under IFRS? We recommend that the Board clarify the meaning of ‘existing contract’.

And last but not least, we understand that the Board has resumed its work on the Provisions research project. We recommend that as part of this project the Board revisits the guidance on future operating losses to address any inconsistency with other parts of guidance in IAS 37.