KPMG

Assessing if a contract is onerous

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Proposed amendments to IAS 37 could increase contract loss provisions for some

Highlights

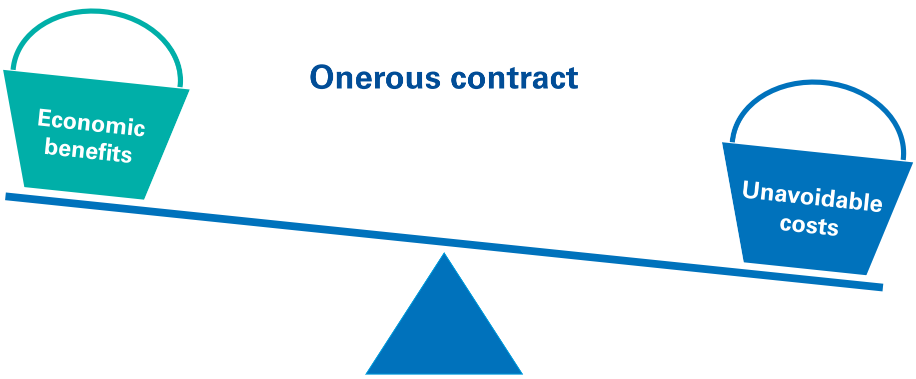
- What's the issue? – Determining if a contract is onerous
- What's the Board proposing? – Clarifying which costs are 'unavoidable'
- Have your say by 15 April 2019

The International Accounting Standards Board (Board) is proposing to amend IAS 37 to specify which types of costs a company includes as the 'costs of fulfilling a contract' when assessing whether a contract is onerous.

What's the issue?

Until recently, there were two different tests to determine if a sales contract is loss-making: one in IAS 11 *Construction Contracts* for construction contracts and one in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for other contracts. This changed with the new revenue standard. All contracts are now subject to the test in IAS 37 – is the contract 'onerous'?

IAS 37 specifies that a contract is 'onerous' when the unavoidable costs of fulfilling it outweigh the economic benefits.



"The proposals are timely and necessary, and would bring welcome clarity. But it remains to be seen whether others will agree with including allocations of fixed costs when assessing whether a contract is onerous."

Prabhakar Kalavacherla (PK)
KPMG's global IFRS revenue recognition leader

But what does 'unavoidable' mean? Some believe that 'unavoidable' is an incremental cost concept, consistent with the general requirement not to provide for future operating losses, while others believe that it is a full cost concept.

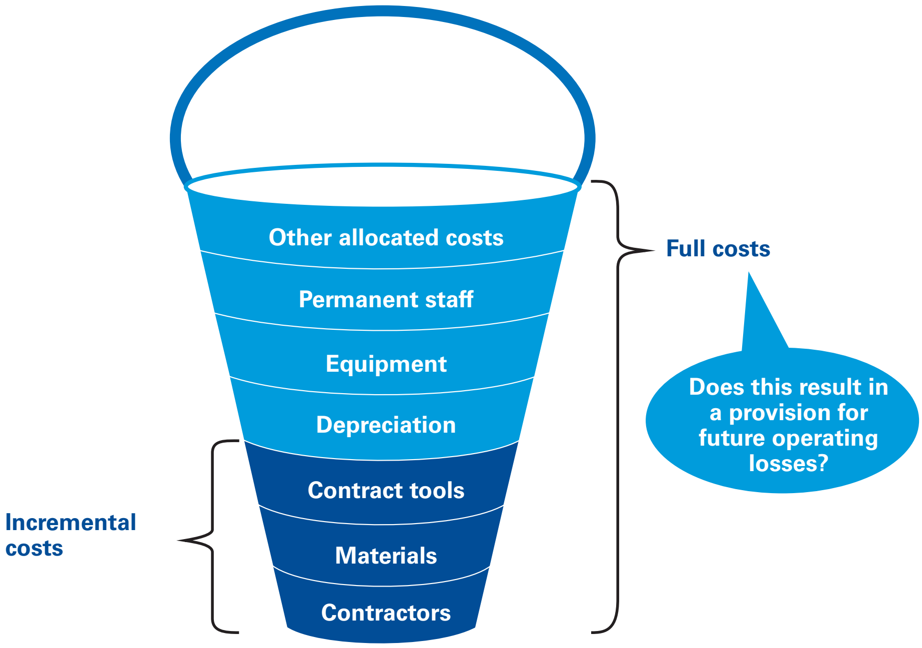
Companies applying the 'incremental cost' approach may need to recognise more – and – bigger provisions in the future

This difference in view matters because an incremental cost approach results in fewer contracts being identified as onerous than a full cost approach. And it matters more than ever, because most sales contracts will now be assessed under IAS 37 following the withdrawal of IAS 11. Therefore, the Board's proposals to remove this diversity in practice are both timely and necessary.

What's the Board proposing?

The Board seems to have landed on a version of full cost. It is proposing to amend IAS 37 to clarify that the unavoidable costs of fulfilling a contract include incremental costs plus 'an allocation of other costs directly related to the contract'. It provides examples of the types of costs that would be included – see the diagram below.

The proposals are unlikely to affect companies that already apply the 'full cost' approach, but those who apply the 'incremental cost' approach may need to recognise more – and – bigger provisions in the future. But not until the amendments are finalised – there is no immediate change in 2018 reports.



The proposed amendments would apply prospectively to contracts existing when the amendments are first applied.

Have your say

We encourage you to take the opportunity to have your say on **the proposals**. The deadline for comments is 15 April 2019.