

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

You can submit your comments on EFRAG's draft comment letter by using the [‘Express your views’](#) page on EFRAG website (then open the relevant news item and click on the 'Comment publication' link at the end of the news item to attach your response letter).

Comments should be submitted by Friday 5 April 2019.

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

XX Month 2019

Dear Mr Hoogervorst,

Re: ED/2018/2 *Onerous Contracts - Cost of Fulfilling a Contract: Proposed amendments to IAS 37.*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on Exposure Draft ED/2018/2 *Onerous Contracts - Cost of Fulfilling a Contract: Proposed amendments to IAS 37* issued by the IASB on 13 December 2018 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS Standards in the European Union and European Economic Area.

EFRAG welcomes and supports the amendments proposed in the ED and believes that they will clarify the requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* regarding the assessment of whether, in a contract, the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. In our view, this will improve the quality of financial reporting under IFRS Standards.

EFRAG's detailed comments and responses to the questions in the ED are set out in Appendix to this letter.

If you would like to further discuss our comments, please do not hesitate to contact Robert Stojek, Almudena Alcalá or me.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix - EFRAG's responses to the questions raised in the ED

Note to constituents – Summary of proposals in the ED

- 1 *IAS 37 Provisions, Contingent Liabilities and Contingent Assets defines an onerous contract as one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. IAS 37 also states that 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. However, IAS 37 does not specify which costs to include when determining the cost of fulfilling a contract.*
- 2 *The objective of the proposed amendments to IAS 37 is to specify the costs an entity includes as the 'cost of fulfilling a contract' when assessing whether a contract is onerous.*
- 3 *The IASB is proposing that the costs of fulfilling a contract are all the costs that relate directly to the contract rather than limiting the costs of fulfilling a contract to the incremental costs related to the contract. The IASB considers that using the costs that relate directly to the contract would provide more useful information as the incremental costs approach would fail to identify an onerous contract provision when an entity has several contracts that are expected to be profitable individually if the economic benefits are compared with only the incremental costs but are lossmaking when shared costs are included.*
- 4 *The IASB proposes that the amendments should be applied at the beginning of the annual reporting period in which the entity first applies the amendments (the date of initial application). Comparative information should not be restated. Instead, the entity should recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings at the date of initial application.*

Question 1

The IASB 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 IASB'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?

EFRAG's response

EFRAG supports the proposal to specify that the 'cost of fulfilling a contract' comprises the costs that relate directly to the contract, rather than the incremental costs of the contract.

EFRAG acknowledges that the wording of proposed paragraph 68A of IAS 37 is aligned with paragraph 97 of IFRS 15 *Revenue from Contracts with Customers* which defines "costs that relate directly to a contract". However, EFRAG considers that it would be useful to clarify that the costs of fulfilling the contract are costs yet to be incurred rather than costs already incurred.

The proposed amendment

- 5 EFRAG supports the IASB's initiative to address the issue in order to reduce the identified diversity in practice, and consequently to improve financial reporting.
- 6 EFRAG acknowledges that judgement would have to be applied in distinguishing the costs that relate directly to fulfilling a contract. However, EFRAG considers that the judgement required will not exceed the judgements already required in applying IFRS 15.
- 7 EFRAG considers that the proposed amendments will provide more relevant information to users of financial statements by providing guidance that was removed from IFRS Standards when IFRS 15 was issued. We anticipate that the proposed amendments will lead to more comparable assessments of onerous contracts.
- 8 EFRAG notes that paragraph 68A in IAS 37 refers to cost of fulfilling a contract. We consider that the first sentence of that paragraph should clarify that the costs of fulfilling the contract are costs yet to be incurred. That is, we recommend that the IASB clarify that direct costs arising after compromise in the contract and should be recognised in profit or loss in accordance with applicable Standards.

Transitional provisions

- 9 Although EFRAG usually supports full retrospective application of IFRS Standards, in this case, EFRAG agrees with the IASB's proposal to limit retrospective application of the proposed amendments. Full retrospective application of the proposed amendments is likely to be burdensome to apply, could require the use of hindsight and the benefits of restatement are likely to be outweighed by the costs.

Note to constituents – Costs that do and do not relate directly to the contract

- 11 *The IASB proposes to clarify that the cost of fulfilling a contract comprises the costs that relate directly to the contract, and to add the following paragraphs 68A–68B to the IAS 37 guidance:*

Paragraph 68A - Examples of costs that relate directly to a contract to provide goods or services include:

- (a) direct labour (for example, salaries and wages of employees who manufacture and deliver the goods or provide the services directly to the counterparty);*
- (b) direct materials (for example, supplies used in fulfilling the contract);*
- (c) allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance and depreciation of tools, equipment and right-of-use assets used in fulfilling the contract);*
- (d) costs explicitly chargeable to the counterparty under the contract; and*
- (e) other costs incurred only because an entity entered into the contract (for example, payments to subcontractors).*

Paragraph 68B - General and administrative costs do not relate directly to a contract unless they are explicitly chargeable to the counterparty under the contract.

Question 2

The IASB 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.

EFRAG's response

EFRAG supports the proposal of the IASB. However, paragraph 68A(d) of the ED refers to costs that are explicitly chargeable to the counterparty. To ensure that costs are not overstated, it could be useful to either limit paragraph 68A(d) to costs that are explicitly chargeable and are not expected to be recovered or amend paragraph 68 to note that the economic benefits expected to be received include the reimbursement of costs that are explicitly chargeable to the counterparty.

- 12 EFRAG agrees with the IASB's decision to include paragraph 68A and 68B of the ED. However; EFRAG notes that paragraph 68A(d) of the ED refers to cost explicitly chargeable to the counterparty under the contract. We consider that paragraph 68A(d) should be limited to costs that are explicitly chargeable and the economic benefits expected to be received include the reimbursement of costs that are explicitly chargeable to the counterparty. That is, we recommend that the IASB clarify that costs explicitly chargeable and are not expected to be recovered by the entity and should be recognised in profit or loss in accordance with applicable Standards.

IASB ED Costs Considered in Assessing Whether a Contract is Onerous - Proposed amendments to IAS 37

Question 3

Do you have any other comments on the proposed amendments?

EFRAG's response

EFRAG has no further comments.