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International Accounting Standards Board
Columbus Building
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Canary Wharf
London E14 4HD
United Kingdom

XX AprilMonth 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 the IASB's efforts to 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. However, EFRAG encourages the IASB to further discuss the potential impact of the proposed amendments on contracts in the scope of the IAS 37 onerous assessment but not previously in the scope of IAS 11 *Construction Contracts*.

EFRAG's detailed comments and responses to the questions in the ED are set out in the 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 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 loss-making 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 specifying 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.

However, EFRAG encourages the IASB to further discuss the potential impact of the proposed amendments on contracts in the scope of the IAS 37 onerous assessment but not previously in the scope of IAS 11.

The proposed amendment

- 51** EFRAG supports the IASB's initiative to reduce the identified diversity in practice regarding the assessment of the cost of fulfilling a contract, and consequently to improve financial reporting.

- 62 EFRAG notes that the IASB launched the project in response to a submission to the IFRS Interpretations Committee requesting it to clarify the meaning of 'unavoidable costs of meeting the obligation' for ~~the~~ contracts previously in the scope of IAS 11 *Construction Contracts* and now in the scope of IFRS 15 *Revenue from Contracts with Customers*.
- 73 In that context, EFRAG agrees with the reasoning provided in paragraphs BC18 to BC23 of the ED that the directly-related cost approach provides a more faithful representation of the cost of fulfilling a contract than the incremental cost approach. This is because the incremental cost 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 loss-making once shared costs are included.
- 84 Therefore, EFRAG considers that the proposals will lead to more relevant information for users of financial statements by providing guidance that was removed from IFRS Standards when IAS 11 was withdrawn. This will reduce diversity in practice and, consequently, will lead to more comparable assessments of onerous contracts.
- 95 EFRAG acknowledges that judgement would need to be applied when identifying the costs that relate directly to a contract. ~~However,~~ EFRAG considers that such judgement is already required when applying IFRS 15. However, in our opinion, the difference between the directly related cost approach and the incremental cost approach is not outlined sufficiently clearly to provide relevant guidance for preparers. Therefore, EFRAG urges the IASB to provide more explanations on the differences between those two approaches.

Scope of the ED

- 106 EFRAG agrees with the explanation provided in paragraph BC6 of the ED that the withdrawal of IAS 11 and application of IFRS 15 makes clarification of the onerous contract requirements urgent, and that providing clarification in a discrete project rather than waiting for the full review of IAS 37 reflects this urgency.
- 117 However, EFRAG notes that proposed amendments will affect the onerous assessment not only for long-term construction contracts previously in the scope of IAS 11 but for all contracts in the scope of IAS 37. This includes, for example, other contracts with customers in the scope of IFRS 15, ~~and also~~ contracts to purchase goods or services outside the scope of IFRS 15.
- 128 EFRAG also notes the IASB's explanation for the proposed scope of the clarification, and that the IASB has undertaken some research ~~that indicated~~ indicating that provisions for onerous lease contracts make up a significant proportion of the contracts identified as onerous applying IAS 37. However, it is not apparent that the IASB has investigated the extent to which the directly-related or incremental cost approach is currently applied to contracts in the scope of IAS 37 (but not IAS 11). Accordingly, the expected impact of the proposals on existing financial reporting practices is difficult to evaluate. Moreover, the ED's proposed guidance on examples of costs that are directly-related, and the arguments as to why such an approach provides more relevant information, seem to consider only revenue contracts and no other contracts within the scope of the IAS 37 onerous test.
- 139 For these reasons EFRAG encourages the IASB to further assess the expected impact of the proposals on contracts in the scope of the IAS 37 onerous assessment but not previously in the scope of IAS 11, and further discuss the types of directly-related cost that would apply to non-revenue contracts and why such an approach is more relevant for these contracts.

~~Transitional provisions~~

~~14 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.~~

Question to Constituents

~~15 EFRAG notes that the impact of the proposals goes beyond the contracts with customers in the scope of IFRS 15. What is your perceived impact of the amendments that should be considered by the IASB when finalising the amendments? Please provide the relevant contract examples.~~

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.

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

~~16 The IASB proposes to include the examples of costs that do or do not relate directly to the contract, and to add the following paragraphs 68A–68B to the IAS 37 requirements:~~

~~**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).~~

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

EFRAG's response

EFRAG supports the IASB's proposal to include the examples of the costs that relate directly to a contract.

Examples of the costs that relate directly to a contract

[4710](#) EFRAG welcomes the IASB's effort to provide guidance in IAS 37 on costs that relate directly to a contract. EFRAG also notes that the proposed guidance is consistent with the guidance on contract costs in IFRS 15. However, EFRAG notes that guidance on 'direct costs' and 'directly attributable costs' differs in other IFRS Standards.

[4811](#) EFRAG agrees with the IASB's decision to add paragraphs 68A and 68B to the requirements of IAS 37 to clarify which costs an entity should consider when determining the cost of fulfilling a contract to provide goods or services. EFRAG also acknowledges that the wording of paragraph 68A of the ED is aligned with paragraph 97 of IFRS 15. However, EFRAG suggests that the IASB should better explain in paragraph 68B of the ED which types of costs should not be included when determining the cost of fulfilling a contract.

[4912](#) Moreover, as explained in paragraph 12 above, EFRAG notes that the scope of the IAS 37 onerous test also includes purchase contracts. Therefore, EFRAG suggests that the IASB should also consider examples of specific types of costs that should be included when assessing purchase contracts.

[2013](#) However, EFRAG questions the assertion in paragraphs BC24 and BC25 of the ED that the proposed definition of directly related costs is consistent with requirements in other IFRS Standards for the measurement of non-monetary assets. We acknowledge that the terms and labelling 'direct' or 'directly related' are commonly used in IFRS literature, but not necessarily with consistent meaning. For instance, IAS 2 *Inventories* explains that the cost of inventory also includes 'indirect costs of production', e.g. a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods, which in accordance with the proposed paragraph 68A would be referred to as 'costs that relate directly to a contract'.

[2414](#) EFRAG also notes that paragraph BC26 of the ED states that, ideally, the way an entity determines the cost of fulfilling a contract to deliver goods should be consistent with the way in which it determines the cost of those goods when it holds them.

[2215](#) EFRAG therefore suggests that the IASB should, in the longer term, further assess the guidance on 'direct costs' and 'directly attributable costs' across IFRS Standards whether the differences in terminology and guidance are justified in circumstances and cause any application difficulties. The broader IAS 37 project could be a suitable vehicle for this review.

Question 3

Do you have any other comments on the proposed amendments?

EFRAG's response

EFRAG raises a concern whether the IAS 37 guidance regarding onerous contracts provides enough explanations on the sequence of application of particular IFRS Standards.

EFRAG also urges the IASB to consider and discuss the notion of economic benefits in paragraph 68 of IAS 37 in the context of the overall review of IAS 37.

Transitional provisions

16 EFRAG usually supports full retrospective application of IFRS Standards. However, in this case, full retrospective application of the proposed amendments

is likely to be burdensome to apply and the benefits of restatement are likely to be outweighed by the costs. Moreover, EFRAG observes that only in a limited number of cases would full retrospective application not require the use of hindsight (for example, when contract cost only comprises incremental costs). EFRAG, therefore, agrees with the IASB's proposal to limit retrospective application of the proposed amendments.

Sequence of application

[2317](#) EFRAG notes that paragraph 69 of IAS 37 already includes the requirement to recognise in accordance with IAS 36 *Impairment of Assets* any impairment loss that has occurred on assets dedicated to that contract.

[2418](#) However, EFRAG also notes that IAS 36 requirements do not apply to all assets used or recognised by entities when fulfilling the contract obligations. This includes for example inventory which is recognised and measured in accordance with IAS 2, or contract assets, which are tested for impairment in accordance with IFRS 15. Consequently, applying only the requirements of IAS 36, may lead to overstating the recognised cost.

[2519](#) EFRAG, therefore, urges the IASB to consider clarifying the requirements of paragraph 69 of IAS 37 and explaining that before establishing a provision for an onerous contract, entities should remeasure the assets carried due to fulfilling the contract obligations in accordance with appropriate IFRS Standard, and then test them for impairment, in accordance with IAS 36 or other appropriate IFRS requirements.

[20](#) Furthermore, EFRAG suggests that the IASB explain better the application of impairment and onerous tests in subsequent years after the recognition of an impairment or a provision for onerous contracts e.g. in situations of reversal of an impairment loss.

Economic benefits

[2621](#) EFRAG acknowledges the reasoning provided in paragraph BC15 of the ED not to address the questions regarding the meaning of 'economic benefits' referred to in paragraph 67 of IAS 37. However, EFRAG considers that the assessment of 'economic benefits' in paragraph 67 of IAS 37 also needs a more thorough explanation.

[2722](#) EFRAG therefore urges the IASB to consider and discuss the clarifications regarding the notion of 'economic benefits' during the overall review of IAS 37 requirements in future.