

IFRS Foundation
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5 April 2019

Dear Sirs

Onerous Contracts—Cost of Fulfilling a Contract: Proposed amendments to IAS 37
(ED/2018/2)

1 This letter sets out the views of the FRC on the above Exposure Draft. We summarise our main views below, which are broadly supportive. This is followed by observations on some issues where further clarification is desirable. While it may not be possible to provide all such clarifications within the present project, we urge the IASB to consider them, if not as part of this project, then elsewhere perhaps within its wider review of IAS 37.

2 Our responses to the questions raised in the Exposure Draft are set out in the Appendix to this letter.

Points of agreement

3 We welcome the main proposal in the Exposure Draft to provide greater clarity in the costs that should be considered in relation to determining whether a contract is onerous. This is a pragmatic response to the uncertainty arising from the transfer of onerous long-term construction contracts from IAS 11 to IAS 37.

4 The Exposure Draft identifies two approaches to determining the cost of fulfilling a contract: ‘the incremental cost approach’ and ‘the directly related cost approach’: we agree that specifying the use of the latter is likely to result in more useful information and is more consistent with requirements of other IFRSs.

5 We also agree that the amendments to IAS 37 should apply to all contracts within the scope of IAS 37. Restricting the scope to contracts formerly falling under IAS 11 would lack conceptual justification. It would also increase the complexity of IFRSs and therefore reduce the understandability of financial statements prepared in accordance with IFRSs. We also agree that the introduction of IFRS 16 ‘Leases’ reduces the number of contracts that are identified as onerous and hence fall to be accounted for under the requirements of IAS 37.

Clarifications

Only assessment or measurement as well?

6 IAS 37 does not make a distinction between (i) the costs to be considered in assessing whether a contract is onerous; and (ii) the costs that should be reflected in determining the amount of a provision in respect of such a contract. It is unclear whether the Exposure Draft is intended to secure the use of the 'directly related cost approach' for the latter as well as the former. The Introduction to the Exposure Draft and paragraph BC13 suggest that it is limited to (i); paragraph BC 14 states '*an entity could measure an onerous contract provision by including the same costs as it used to identify the contract as onerous*' (emphasis added). However, paragraph BC23(a) states:

in recognising an onerous contract provision, an entity would...be recognising its present obligation to deliver goods or services in exchange for other economic benefits, measuring that obligation at an amount that includes all the costs of fulfilling it. (emphasis added)

7 It is not obvious why there should be any difference between the costs that are relevant in assessing whether a contract is onerous and those that should be reflected in a provision for that contract. A clear requirement to that effect would remove any uncertainty on the point.

Costs of failure to fulfil

8 IAS 37 states (paragraph 68) 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.

9 The Exposure Draft focuses on the 'cost of fulfilling' the contract, but the standard's description of costs arising from failure to fulfil seems inadequate and would benefit from amplification. The description gives only two examples—compensation and penalties—but there may be other costs that should be considered.

10 A relatively minor amendment that would go some way to meeting this point would be as follows:

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 the costs arising from failure to fulfil it including any compensation or penalties arising from failure to fulfil it.

Impairment of assets dedicated to a contract

11 The present project provides an opportunity to update paragraph 69 of IAS 37, by adding references to standards other than IAS 36 that are relevant to the recognition of impairment losses, perhaps similarly to the drafting of paragraph 103 of IFRS 15.

Further research on the concept of 'costs'

12 The Exposure Draft considers only two perspectives of cost: 'incremental cost' and 'directly related cost'. It is not clear to us that this exhausts the possibilities and we also believe that the terminology may not be the same as that used in the management accounting literature.

13 Although, as stated above, we agree that the Exposure Draft's proposals will provide helpful clarity, and therefore support taking them forward, we believe that the IASB should undertake further research into the notion of costs and the role they should play in financial reporting. This could be linked with an exploration of the conceptual basis for historical cost accounting, which we urged in our response to the Exposure Draft 'Property, Plant and Equipment—Proceeds before Intended Use' (ED/2017/4).

14 This could be linked with a review of the usage of terms such as 'direct costs' and 'directly attributable costs' within IFRSs. Despite BC24-25 we are not convinced that all relevant IFRSs use these and similar terms with identical meaning and whether any differences are justified.

Should you wish to discuss any of these points in detail, please contact Andrew Lennard a.lennard@frc.org.uk 020 7492 2430.

Yours sincerely



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