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Dear Sir

Exposure Draft ED/2018/2 Onerous Contracts – Cost of Fulfilling a Contract

We are pleased to comment on the above Exposure Draft (the ED). Following consultation with the BDO network[1], this letter summarises views of member firms that provided comments on the ED.

Our responses to the questions in the ED are set out in the attached Appendix.

We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact me at +44 (0)20 7893 3300 or by email at abuchanan@bdoifra.com.

Yours faithfully

Andrew Buchanan.

Andrew Buchanan

*Global Head of IFRS*

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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?*

We do not agree with the proposed amendment to paragraph 68 of IAS 37. Our primary concern is that by defining costs to be included in the calculation of a potentially onerous contract as those that are directly attributable, including some costs that may not be incremental in nature, the application of the standard may result in outcomes that are not logical from a commercial perspective.

To illustrate our concern, assume that an entity is in a binding contract with a customer within the scope of IFRS 15 (amounts presented as 'currency units' – CU). The entity is determining whether the contract is onerous, and thus compares the total revenue to be recognised in the contract (CU 9) to the lesser of:

1) Cost of fulfilling (i.e. directly attributable costs); and
2) Compensation or penalties arising from failure to fulfil.

The cost of fulfilling the contract is CU 12 comprised of:

- CU 8 of direct materials that have been specifically ordered for the contract and have no alternative use for other customers or contracts; and
- An allocation of CU 4 of other directly attributable costs such as insurance, depreciation of tools, equipment, etc., as noted in the proposed paragraph 68(c) of IAS 37.

The penalty for non-performance is CU 10.

Applying IAS 37.68 as proposed in the ED, the unavoidable costs under a contract would be CU 10, as that represents the lower of items (1) and (2) noted above. This outcome is not intuitive, since it assumes that the entity would prefer to cancel the contract and pay a termination penalty as opposed to continuing to satisfy the performance obligations in the contract. In the instance described above, we believe it would be most common for an entity to choose to continue satisfying its outstanding performance obligation as the costs that are truly unavoidable in this case are CU 8 (the direct materials that may only be used in this contract) compared to CU 10 of termination penalties. The CU 4 of other costs likely relate to many other contracts, which significantly affects the entity's decision as to whether to continue with the contract or to pay the termination penalty of CU 10.

In the case of this example, under the proposals in the ED an onerous contract would exist as total revenue of CU 9 is less than the lesser of items (1) and (2); therefore, a CU 1 onerous contract liability would be recognised. An onerous contract exists in this case, despite the fact that, assuming the entity is planning to continue commercial activities, they would be highly unlikely to actually choose to pay the penalty to terminate the contract.

The onerous contract provision represents only non-incremental costs to be incurred in the future at the discretion of the entity (i.e. those costs that exceed the incremental costs of CU 8), which is inconsistent with IAS 37.63, which precludes the recognition of provisions for future operating losses. BC23 of the ED notes that the Board does not feel that this requirement is inconsistent with paragraph 63, since the onerous contract represents the cost of fulfilling its present obligations (i.e. the outstanding performance obligations in the contract with the customer), not an obligation to incur future expenses. We do not agree with this conclusion, since the inclusion of such costs in the 'lesser of' test to determine the unavoidable costs under a contract results in conclusions inconsistent with the commercial reality.

BC19 and BC20 of the ED notes that the Board felt that including costs that are not strictly incremental in nature would provide more useful information to users of financial statements. We do not agree with this conclusion, as presenting onerous contract liabilities based on underlying assumptions that are not consistent with how an entity plans to operate and does not provide users of financial statements predictive information.

*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 do not agree with the proposed guidance provided in paragraph 68A of IAS 37 for the reasons discussed in question 1. The examples provided, specifically those in paragraph 68A(c), include costs that are not incremental to a contract, which we are not in agreement with.

Consistent with this point, 68B notes that general and administrative costs must be explicitly chargeable to the counterparty under the contract for them to be directly related. We consider that regardless of whether they are chargeable or not, general and administrative costs are, by their nature, not incremental, and therefore should not be included as incremental costs in an onerous contracts calculation.

*Question 3 - Do you have any other comments on the proposed amendments?*

We are concerned that the proposed amendments are inconsistent with the definition of an onerous contract, which remains unchanged. IAS 37.10 defines an onerous contract as (emphasis added) 'a contract in which the <u>unavoidable costs</u> of meeting the obligations under the contract exceed the economic benefits expected to be received under it.'

While the definition of an onerous contract remains focused on 'unavoidable costs', the proposed amendments broaden the underlying calculations required to determine if an onerous contract exists to include some costs that are not 'unavoidable' (i.e. costs that relate directly to a contract that are not unavoidable, such as those noted in the proposed paragraphs 68A(c)).

In our view, it is inappropriate to alter the underlying mechanics of the calculations relating to onerous contracts when those changes are inconsistent with the definition of an onerous contract.