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

Dear Mr Hoogervorst

We are pleased to respond to the IASB's Exposure Draft in respect of the matter listed above.

We welcome the IASB's issuance of this amendment to IAS 37. We agree that there is a lack of clarity in the current wording in IAS 37 about what is meant by "unavoidable costs" of fulfilling a contract. We are aware of diversity in practice, across sectors and across entities within the same sector, in the determination of whether, and to what extent, a contract is onerous. This diversity of practice gives rise to a lack of comparability of financial information, and therefore requires clarification. This is particularly the case for contracts previously recognised in line with IAS 11, but applies equally to other contracts.

We are supportive of the Board's proposal to define the cost of fulfilling a contract as the costs that directly relate to the contract, rather than only the incremental costs of fulfilling it. We consider this approach captures all the costs which cannot be avoided from the existence of the contract, regardless of the way the entity may choose to fulfil it. An incremental-costs-only approach could fail to capture resources held by the entity which would have to be directed to fulfilling the contract, and therefore is unlikely to provide a comprehensive comparison point against the benefit expected to arise from a contract. Indeed, in circumstances where an entity is already contractually committed to incur the full costs of fulfilling a loss-making contract, the incremental costs – understood as those costs which would not be incurred if the entity did not have a particular contract in place – could be quantified as nil, which does not seem representative of the intention of IAS 37.

We set out more detailed reasons for our position below, responding to each of the IASB's questions in its Invitation to Comment.

We would be pleased to respond to any comments the Board or its staff may have about our response. If you have any questions or comments please do not hesitate to contact Ralph Martin (+61 (0)8 9261 9374) or me (+44 (0)207 601 1077).

Yours faithfully,

Marion Hannon
Global Leader, Quality &Risk
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Appendix: RSM's Response to Specific Matters for Comment requested by the IASB

Q1 - 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 agree with this proposal.

The context of the definition of 'costs of fulfilling a contract' is the determination of whether a contract is an onerous contract or not – that is, one in which the costs of fulfilling the contract exceed the benefits expected to be received from it.

As a provision requires the identification of the "resources embodying economic benefits" which would be "required to settle the obligation", it would be consistent with the overall objective of IAS 37 ("the standard") to include in the definition of "costs of fulfilling a contact" all of the costs which an entity cannot avoid in light of the existence of the contract – that is, all the costs which relate directly to the contract, or all the resources required to settle the obligation. We acknowledge that the measurement of the 'costs of fulfilling a contract' is outside the scope of this ED.

We further consider that this definition would increase comparability of financial statements, and increase consistency across accounting standards:

- BC18 explains that the directly-related cost approach achieves comparability irrespective of how an entity sources the inputs to deliver a contract (e.g. use of own staff vs outsourcing, use of owned equipment vs hiring). Additionally, it specifies that whilst the allocation of internal costs involves greater estimation than identifying direct costs incurred externally, this additional estimation should be disclosed in accordance with IAS 1.125. We concur with this assessment, and believe that it merits inclusion within the standard itself, rather than the Basis for Conclusions.
- BC20 specifies that grouping similar contracts which share costs masks losses on one contract by offsetting profits on another contract. This is consistent with the IAS 36.7 requirement to apply impairment requirements to "an asset" and those of IAS 16.39&40 only offsetting revaluation gains/losses on the "same asset"

As this is in line with the objective of the conceptual framework, we are supportive of this clarification.

Q2 – [On costs that do, and do not, relate directly to a contract.] Do you have any comments on the items listed? Do you have any other examples you think the Board should consider adding to those paragraphs?

We accept the examples provided as being relevant. However, we consider that in addition to the specific examples:

1. There should be a clear principle underlying the examples, to avoid the divergence in practice which the ED aims to address as well as avoiding future requests for clarification about whether specific costs are included or excluded;
2. There should be specific guidance on the content of cost allocations; and
3. The costs explicitly described should go beyond the examples of costs to fulfil a contract as set out in IFRS 15.97-98 (as clarified in BC29).

In relation to an underlying principle, we consider it could address, for instance:

- ***IAS 11 cost categories*** – The ED includes examples of "costs that relate directly to the specific contract", which had previously fallen into other separate cost categories in IAS 11.16. For example, "costs that are attributable to contract activity in general and can be allocated to the contract"; and "such other costs as are specifically chargeable to the customer under the terms of the contract"
- ***Cost allocations*** – why allocations of insurance and depreciation are permitted (68A(c)) but other general and administrative costs are excluded unless they are explicitly rechargeable to the counterparty (68B)

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Specific guidance on cost allocations would help reduce the diversity in practice. As the ED introduces additional cost allocations, specific guidance in this area would reduce manipulation to recognise costs earlier within an onerous contract provision, or exclude costs from an onerous contract provision in order to defer them. Finally, we accept that the examples in 68A are largely aligned with those in IFRS 15.97&98 – which is consistent with the ED being a response to the withdrawal of IAS 11 upon adoption of IFRS 15 – but we consider that the examples should cover other costs. This is because the ED applies to all contracts, including those within the scope of IAS 37 but not IFRS 15. Examples of where further guidance could be provided include:

- ***Leases*** – Extending the examples to include lease costs that 'relate directly to a contract' would be consistent with the scope applying to all contracts
- ***Capitalisation*** – Costs which make a contact onerous will extend beyond the capitalised costs to fulfil a contact in IFRS 15 which must meet the definition of an asset:
  "IFRS 15 -.BC308 clarifies that only costs that give rise to resources that will be used in satisfying performance obligations in the future and that are expected to be recovered are eligible for recognition as assets."
- ***Cost of wasted resources*** – As the examples are aligned with IFRS 15, it would be helpful to clarify whether "waste" can be included in the cost of fulfilling a contract (they are excluded from capitalised costs under IFRS 15.98(b), presumably due to there being no economic benefit)

Q3 – Do you have any other comments on the proposed amendments?

While we acknowledge the time-sensitive nature of this ED, and appreciate the Board's recognition of the need to consider the measurement of the provision as part of a whole-scale review of IAS 37, we consider that this ED could provide clarity on whether the costs used to identify a contract as onerous (that is, as described above, the 'directly attributable costs' of the contract) are those to include in the measurement of an onerous contract provision. We note in particular that BC14 says this approach 'could' be applied, but does not conclude either way. We believe this may create diversity in practice

Moreover, we consider that there may not be consistency between the meaning of 'directly attributable costs' in the context of this ED compared to the meaning of 'directly attributable costs' when considering the capitalisation of an asset. This is because costs identified as capitalisable costs as part of an asset include an expectation of future economic benefits, whereas costs of an onerous contract will often (by their nature) not give rise to expected future economic benefit. A note could be included to specify that comparison to capitalised costs could be used as a 'base level' of costs to be included in the assessment of whether a contract is onerous

Finally, we agree that a project on economic benefits should be kept beyond the scope of this ED, due to the reasons set out in BC15 (being that it would delay the timescale for clarity on costs) but do consider that this is an important aspect of IAS 37 which requires further clarification, so would encourage the Board to consider this issue within its future work programme.

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