John Berrigan
Director General, Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Brussels

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Dear Mr Berrigan

Endorsement of Onerous Contracts - Cost of Fulfilling a Contract

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, EFRAG is pleased to provide its opinion on the Onerous Contracts - Cost of Fulfilling a Contract, Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (‘the Amendments’), which were issued by the IASB on 14 May 2020. An Exposure Draft of the Amendments was issued on 13 December 2018. EFRAG provided its comment letter on that Exposure Draft on 24 April 2019.

The objective of the Amendments is to clarify the requirements of IAS 37 on onerous contracts 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.

The Amendments shall be applied for annual periods beginning on or after 1 January 2022, with earlier application permitted. If entities apply the Amendments earlier, they shall disclose that fact. A description is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have first assessed whether the Amendments would meet the technical criteria for endorsement, in other words whether the Amendments would provide relevant, reliable, comparable and understandable information required to support economic decisions and the assessment of stewardship, lead to prudent accounting and are not contrary to the true and fair view principle. We have then assessed whether the Amendments would be conducive to the European public good. We provide our conclusions below.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

EFRAG has concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability, and understandability required to support economic decisions and the assessment of stewardship and raise no issues regarding prudent accounting.

EFRAG has also assessed that the Amendments do not create any distortion in their interaction with other IFRS Standards and that all necessary disclosures are required. Therefore, EFRAG has concluded that the Amendments are not contrary to the true and fair view principle. EFRAG’s reasoning is explained in Appendix 2 to this letter.

Are the Amendments conducive to the European public good?

EFRAG has assessed that the Amendments would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that the Amendments could have any adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that endorsing the Amendments is conducive to the European public good. EFRAG’s reasoning is explained in Appendix 3 to this letter.

In EFRAG's assessment of whether the Amendments would be conducive to the European public good, EFRAG has assessed whether the Amendments would improve financial reporting, would reach an acceptable cost-benefit trade-off, and whether the Amendments could affect economic growth.

Our advice to the European Commission

As explained above, we have concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, that they raise no issues regarding prudent accounting and that they are not contrary to the true and fair view principle. We have also concluded that the Amendments are conducive to the European public good. Therefore, we recommend the Amendments for endorsement without further delay.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix 1: Understanding the changes brought about by the Amendments

Background of the Amendments

1 Paragraph 68 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* defines a contract as onerous when 'the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it'.

2 In 2017, the IFRS Interpretations Committee (the IFRS IC) received a request to clarify what costs an entity considers when assessing whether a contract is onerous. The IFRS IC decided that the application of IFRS 15 *Revenue from Contracts with Customers* makes the clarification of IAS 37 onerous contract requirements necessary and urgent. Accordingly, the IFRS IC recommended the IASB to clarify the IAS 37 onerous contract requirements separately from the IASB's research project on provisions.

3 Following the IFRS IC discussion and recommendation, the IASB observed that, from January 2018, contracts that were within the scope of IAS 11 *Construction Contracts* are within the scope of IFRS 15. IFRS 15 does not include requirements for identifying, recognising, and measuring onerous contract liabilities and, instead, IAS 37 provides guidance on assessing whether a contract is onerous.

4 In response to a request to clarify what costs an entity considers when assessing whether a contract is onerous, the IASB tentatively decided that the cost of fulfilling a contract comprises the costs that relate directly to the contract and decided to provide a list of such costs. In December 2018, the IASB published its proposals in the Exposure Draft ED/2018/2 *Costs Considered in Assessing Whether a Contract is Onerous (Amendments to IAS 37)*.

5 Following the comment period, the IASB decided to finalise the proposals subject to some modifications.

6 On 14 May 2020, the IASB issued the Amendments.

The issue and how it has been addressed

7 IAS 37 requires a company to classify a contract as onerous when 'the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it'. Sometimes preparers of financial statements find it difficult to interpret this requirement. As a result, entities may classify similar contracts differently, making it hard for investors to understand and compare the financial positions of different entities.

8 To remedy this issue, the Amendments aim to promote consistency in applying the requirements by helping companies determine whether that cost of fulfilling a contract comprises the costs that relate directly to the contract, which would include:

(a) the incremental costs of fulfilling that contract; and

(b) an allocation of other costs that relate directly to fulfilling contracts.

9 The Amendments apply for annual periods beginning on or after 1 January 2022, with earlier application permitted.

What has changed?

10 The IASB added paragraphs 68A and 94A and amended paragraph 69 of IAS 37. The Amendments:

(a) specify that the costs that relate directly to a contract consist of both:

(i) the incremental costs of fulfilling that contract; and

(ii) an allocation of other costs that relate directly to fulfilling contracts.

(b) improve the wording of paragraph 69.

When do the Amendments become effective and the transition requirements?

11 The Amendments apply only to contracts for which an entity has not yet fulfilled all its obligations at the beginning of the annual reporting period in which it first applies the amendments i.e. the date of initial application. The entity shall not restate comparative information. Instead, the entity shall recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings or other component of equity, as appropriate, at the date of initial application.

12 An entity shall apply the Amendments for annual periods beginning on or after 1 January 2022. The IASB decided not to permit retrospective application, as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Earlier application is permitted. If an entity applies the Amendments for an earlier period, it shall disclose that fact.

Appendix 2: EFRAG's technical assessment on the Amendments against the endorsement criteria

Does the accounting that results from the application of the Amendments meet the technical criteria for endorsement in the European Union?

1 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002 (The IAS Regulation), in other words that the Amendments:

(a) are not contrary to the principle set out in Article 4 (3) of Council Directive 2013/34/EU (The Accounting Directive); and

(b) meet the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

2 Article 4(3) of the Accounting Directive provides that:

The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.

3 The IAS Regulation further clarifies that *'to adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic requirement of the aforementioned Council Directives, that is to say that its application results in a true and fair view of the financial position and performance of an enterprise - this principle being considered in the light of the said Council Directives without implying a strict conformity with each and every provision of this Directive'* (Recital 9 of the IAS Regulation).

4 EFRAG's assessment as to whether the Amendments would not be contrary to the true and fair view principle has been performed against the European legal background summarised above.

5 In its assessment, EFRAG has considered the Amendments from the perspectives of both usefulness for decision-making and assessing the stewardship of management. EFRAG has concluded that the information resulting from the application of the Amendments is appropriate both for making decisions and assessing the stewardship of management.

6 EFRAG's assessment on whether the Amendments are not contrary to the true and fair view principle set out in Article 4(3) of Council Directive 2013/34/EU is based on the assessment of whether it meets all other technical criteria and whether they lead to prudent accounting. EFRAG's assessment also includes assessing whether the Amendments do not interact negatively with other IFRS Standards and whether all necessary disclosures are required. Detailed assessments are included in this appendix in the following paragraphs:

(a) relevance: paragraphs 7 to 10;

(b) reliability: paragraphs 11 to 13;

(c) comparability: paragraphs 14 to 21;

(d) understandability: paragraphs 22 to 25;

(e) whether overall, they lead to prudent accounting: paragraphs 26 to 28; and

(f) whether they would not be contrary to the true and fair view principle as noted in paragraphs 29 to 34.

Relevance

7 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present, or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

8 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value, or both – whether it would result in the omission of relevant information.

9 EFRAG assesses that the amendments provide more clarity on which costs to consider when assessing whether the contract is onerous. This clarification will support preparers in applying the principle about onerous contracts already existing in IAS 37. In doing so, the clarification supports the achievement of relevant financial information for estimating future cash flows, for confirming past predictions and for assessing management's stewardship.

10 EFRAG therefore assesses that the Amendments satisfy the relevance criterion.

Reliability

11 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

12 There is a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

13 EFRAG's overall assessment is that the clarifications and explanation brought by the Amendments would result in reducing the potential divergence in practice and, consequently, in the provision of sufficiently reliable information and, therefore, satisfy the reliability criterion.

Comparability

14 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

15 EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

16 Regarding the issues addressed in the Amendments, EFRAG has recognised diversity in practice. For similar transactions either full costs of fulfilling those obligations or incremental costs have been considered by companies. IAS 37 does not specify which costs to include in estimating the cost of fulfilling a contract. Preparers had reached different views on whether to include only the incremental costs of fulfilling that contract (e.g. the cost of materials and labour) or all costs that relate directly to the contract, which are both the incremental costs and an allocation of other costs that relate directly to contract activities. The Amendments clarify that costs that relate directly to the contract have to be considered. Consequently, EFRAG notes that the Amendments have the potential to enhance comparability, in reducing the diversity in practice.

17 However, EFRAG also notes that the Amendments do not further clarify IAS 37 onerous test guidance relating to the assessment of the benefits coming from a

potential onerous contract. This area of the onerous test may still bring diversity in practise. Nevertheless, the Amendments clarify the other part of the onerous test assessment that relates to cost of fulfilling a contract. This element, even considered separately, is expected to reduce the diversity.

18 EFRAG notes, that the Amendments shall be applied only to contracts for which an entity has not yet fulfilled all its obligations at the beginning of the annual reporting period in which it first applies the amendments. The comparative information shall not be restated, and the effect of the initial application will be recognised in the opening balance of the equity at the date of initial application.

19 Consequently, EFRAG notes that in theory the comparability in the context of year-to-year comparability of financial information may be potentially hindered.

20 However, EFRAG notes that the onerous contracts are non-recurring by nature. Therefore, a transition approach that would require restating the comparatives, would not bring useful information. Consequently, EFRAG assesses that the transition approach of the Amendments results in an appropriate balance between the costs for preparers and the information provided to users.

21 EFRAG also notes that the Amendments do not introduce any application options, for instance an option to retrospectively restate the financial information and, therefore, the effect of incomparable financial information is expected to be limited to the transition period.

Understandability

22 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.

23 Although there are a number of aspects related to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability, and comparability.

24 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendment is understandable, is whether that information will be unduly complex.

25 EFRAG assesses that the clarification provided by the Amendments will reduce the divergence in practice and will provide more guidance to entities to reduce differing views on application of IAS 37. Consequently, EFRAG assesses that the Amendments support financial statements providing understandable information.

Prudence

26 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated, and liabilities or expenses are not understated.

27 As mentioned above, the Amendments intend to clarify the requirements of IAS 37 and do not substantially change the existing requirements. EFRAG notes, that allowing to consider only the incremental costs of fulfilling that contract in the onerous test would be less prudent and furthermore, applying the Amendments leads for some companies to apply a more prudent approach.

28 Consequently, EFRAG notes that it has not identified any aspects of the Amendments that would negatively affect prudence.

True and Fair View Principle

29 A Standard will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS Standards, it:

(a) does not lead to unavoidable distortions or significant omissions in the representation of that entity's assets, liabilities, financial position and profit or loss; and

(b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.

30 EFRAG has assessed that the Amendments do not create any negative interactions with other IFRS Standards and are designed to complement IAS 37.

31 EFRAG notes that the wording of the amended guidance is aligned with the requirements of IFRS 15 *Contracts with Customers,* and IFRS 17 *Insurance Contracts*. Furthermore, several IFRS Standard, such as IAS 2 *Inventories*, specify the costs to include in measuring a non-monetary asset. IAS 2 requires companies to include both the incremental costs of purchasing or constructing the asset and an allocation of other directly related or directly attributable costs. The way a company determines the cost of fulfilling a contract to deliver goods should be consistent with the way it measures the cost of those goods when it holds them, therefore, EFRAG assesses that the Amendments are broadly consistent with those requirements.

32 Therefore, EFRAG has assessed that the Amendments do not lead to unavoidable distortions or significant omissions and therefore do not impede financial statements from providing a true and fair view.

33 EFRAG has concluded that the appropriate disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss are required.

34 As a result, EFRAG concludes that the application of the Amendments would not lead to information that would be contrary to the true and fair view principle.

Conclusion

35 Accordingly, for the reasons set out above, EFRAG's assessment is that the Amendments meet the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether the Amendments are conducive to the European public good

Introduction

36 EFRAG considered whether it would be conducive to the European public good to endorse the Amendments. In addition to its assessment included in Appendix 2, EFRAG has considered a number of issues in order to identify any potential negative effects for the European economy on the application of the Amendments. In doing this, EFRAG considered:

(a) Whether the Amendments improve financial reporting. This requires a comparison of the Amendments with the existing requirements and how they fit into IFRS Standards as a whole;

(b) The costs and benefits associated with the Amendments; and

(c) Whether the Amendments could have an adverse effect to the European economy, including financial stability and economic growth.

37 These assessments allow EFRAG to draw a conclusion as to whether the Amendments are likely to be conducive to the European public good. If the assessment concludes there is a net benefit, the Amendments will be conducive to the objectives of the IAS Regulation.

EFRAG's evaluation of whether the Amendments are likely to improve the quality of financial reporting

38 EFRAG notes that the Amendments are designed to clarify specific aspects of the guidance on how to determine the cost of fulfilling a contract for the purpose of assessing whether the contract is onerous.

39 EFRAG has therefore concluded that the Amendments are likely to improve the quality of financial reporting.

EFRAG's analysis of the costs and benefits of the Amendments

40 EFRAG first considered the extent of the work. For some Standards or Interpretations, it might be necessary to carry out some extensive work, in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendments, as they are narrow in scope, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work.

Cost for preparers

41 EFRAG has carried out an assessment of the cost implications for preparers resulting from the Amendments.

42 EFRAG considers that the Amendments are likely to introduce a one-off cost of implementation at the date of initial application. The cost will comprise the costs of amending the company's policy regarding assessments of whether contract is onerous, and eventually the cost of measurement of the provisions for any newly identified onerous contracts at the application date.

43 However, EFRAG also notes the initial costs are limited because the IASB required entities not to apply the Amendments retrospectively and apply them only to contracts that are not finalised at the date of initial application.

44 Regarding the further ongoing cost of application of the Amendments, EFRAG assesses that entities already assess both the incremental costs of production and an allocation of production/service overheads in order to arrive at a pricing decision and to assess their resource planning. Therefore, entities are likely to already have

the information they need to estimate and allocate the costs that will relate directly to contracts into which they have entered.

45 Therefore, EFRAG assesses that the new requirements to estimate and allocate costs that relate directly to a contract would not impose costs that would outweigh the usefulness of the information provided.

Costs for users

46 EFRAG has carried out an assessment of the cost implications for users resulting from the Amendments.

47 EFRAG's assessment is that the Amendments would create a one-off cost for users in reading, understanding the Amendments and ongoing costs relating to updating their analyses which, in turn, is comparable with the cost resulting from existing requirements.

48 Overall, EFRAG's assessment is that the Amendments are likely to result in insignificant costs for users

Benefits for preparers and users

49 EFRAG has carried out an assessment of the benefits for users and preparers resulting from the Amendments.

50 Overall, EFRAG's assessment is that users are likely to benefit from the Amendments, as the information resulting from it will remove inconsistency and increase comparability between entities and therefore will enhance their analysis.

Conclusion on the costs and benefits of the Amendments

51 EFRAG's overall assessment is that the benefits of enhanced consistency of application and increased comparability are likely to outweigh costs associated with complying with the Amendments.

Conclusion

52 EFRAG believes that the Amendments will generally bring improved financial reporting when compared to current guidance. As such, their endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.

53 EFRAG has not identified that the Amendments could have any adverse effect to the European economy, including financial stability and economic growth.

54 Furthermore, EFRAG has not identified any other factors that would mean endorsement is not conducive to the public good.

55 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments, EFRAG assesses that endorsing the Amendments is conducive to the European public good.