AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

C/O KAMMER DER STEUERBERATER UND WIRTSCHAFTSPRÜFER
SCHOENBRUNNER STRASSE 222–228/1/6
A-1120 VIENNA
AUSTRIA

TEL	+43 (1) 81173 228
FAX	+43 (1) 81173 100
E-MAIL	office@afrac.at
WEB	http://www.afrac.at

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RE: ED/2018/2 Onerous Contracts – Cost of Fulfilling a Contract

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, we appreciate the opportunity to comment on IFRS Standards Exposure Draft ED/2018/2 *Onerous Contracts – Cost of Fulfilling a Contract* (the 'ED'), issued by the International Accounting Standards Board (IASB) in December 2018.

Principal authors of this comment letter were Max Eibensteiner, Klemens Eiter, Erich Kandler, Verena Nitschinger, Zoltán Novotny-Farkas and Karl Stückler. In order to assure a balanced Austrian view on the ED, the professional background of these authors is diverse.

Our detailed comments and responses to the questions raised in the ED are set out in the Appendix.

If you would like to further discuss our comments, please do not hesitate to contact us.

Kind regards,

Romuald Bertl

APPENDIX – AFRAC'S RESPONSES TO THE QUESTIONS RAISED IN THE ED

GENERAL REMARKS

AFRAC welcomes and supports the efforts of the IASB to clarify the requirements in IAS 37 regarding onerous contracts. However, we are concerned that the suggested amendment will not improve the relevance of financial information. In particular, we see several unresolved questions which we encourage the IASB to further analyse before issuing an amendment.

The practices of allocating costs that relate directly to a contract vary across companies, business models, cost accounting principles and business situations. Relevant facts and circumstances differ across companies and the approach in the ED is unlikely to enhance the comparability of financial information by making unlike things look alike. Management's view is important in this regard, since external tenders and contract bids are based on the internal cost approach and, therefore, used for (internal) decision making. Therefore, we suggest that the IASB considers a management approach to identify and measure onerous contracts. The internal calculation for tenders can be taken as an objective basis for the evaluation of and accounting for onerous contracts. To enhance relevance and faithful representation, disclosures about the accounting policy for onerous contracts should be improved. Such disclosures would enable users to understand differences in facts and circumstances and accounting practices, and, thus, would increase the comparability of information about onerous contracts.

The examples of costs listed in IAS 37.68A-68B that relate directly to a contract are broadly defined. In particular, it is not clearly recognisable how far the allocation of costs according to IAS 37.68A (c) and IAS 37.68B should reach. Without further specification of industry-specific guidelines, AFRAC expects that (supposed) diversity in practice will not be removed, but instead shifted to the interpretation and judgement of these items. Moreover, the cost of fulfilment represents only one of several aspects (e.g. unit of account, economic benefits) that are relevant for the measurement of onerous contracts. Therefore, it is unclear whether fixing only one unresolved issue will result in more relevant and comparable financial information about onerous contracts.

AFRAC also notes that the IASB launched the project in response to a submission to the IFRS IC with the request to clarify the meaning of "unavoidable costs of meeting the obligation" for those contracts, which were previously in the scope of IAS 11 *Construction Contracts* and are now within the scope of IFRS 15 *Revenue from Contracts with Customers*. Until now, discussions have been limited to certain industries, especially construction. The amendment proposes to extend the scope to a) all industries and b) purchase and other contracts. As far as we can see, the impact on other industries and purchase contracts has not yet been analysed in detail. We encourage the IASB to further assess the impact of the proposed amendments on different industries and contracts taking into account similarities with and differences to other major accounting standards, e.g. US GAAP.

SPECIFIC REMARKS

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?

AFRAC's response:

- **Room for judgement – management's view**

The practices of allocating costs that relate directly to a contract vary across companies, business models, cost accounting principles and business situations. According to cost accounting principles the employment situation has to be considered. Allocation of costs beyond incremental costs also depends on the organisation of an entity. There might be different levels of departments providing overhead services and functions, which – in practice - results in the crucial question, which level is still considered to be directly related to a contract. In our experience the cost allocation practices also vary across different industries. Therefore, relevant facts and circumstances differ and comparability of financial information would not be enhanced by making unlike things look alike.

We believe that management's view is important in this regard since external tenders are based on the internal cost approach and therefore used for (internal) decision making. In our understanding, the internal basis for a tendering is also relevant for external users, as it marks the borderline in judging whether a contract becomes onerous or not. Therefore, we suggest that the IASB considers a management approach to identify and measure onerous contracts. The calculation for tenders can be taken as objective basis for subsequent evaluation. Internal evaluation and measurement have been – and should be – used to communicate loss contracts to users of financial statements. To enhance relevance for users, disclosures about the accounting policy for onerous contracts should be improved. This would enable users to understand the relevant circumstances and accounting practice and increase the relevance of information about onerous contracts.

In many cases, companies only include incremental cost in their management's calculations which we believe can be appropriate as long as it can be expected that those contracts will be fulfilled in the ordinary course of business. The proposed amendments would require these companies to introduce additional cost allocation systems which would not be used for decision making.

- **Materiality and „true and fair view“**

In practice (e.g. in the construction industry as well as in other industries using fixed price contracts), it can be observed that the most relevant loss-making contracts are those displaying losses without considering general and administrative costs. Taking materiality into account, it is important to users that these loss-making contracts are appropriately accounted and disclosed.

It should also be noted that the framework doesn't give priority to the "principle of prudence" in the sense of over-/understatement of provisions but to relevance, which is information useful for the user's decisions. The allocation of costs that relate directly to a contract on a judgemental basis seems to be questionable in this regard.

- **Comparison with other requirements (IAS 2, IAS 16, IFRS 15)**

BC24 and BC25 of the ED conclude that the directly related costs approach is consistent with the requirements in other IFRS standards. However, in contrast to the approach for costs of assets according to IAS 2, IAS 16 and IFRS 15, the fixed costs approach with respect to provisions for onerous contracts does not consider incurred historic costs but future costs. Whilst the relevant costs appear to be the same, the general accounting treatment and logic are different. Future costs are generally reflected in future results. An earlier anticipation is an exceptional treatment and should be limited to situations where it is clear that the costs are the result of an earlier event. As - to some extent - fixed costs are not triggered by a specific contract and, therefore, need to be allocated by using judgement, the relevance of anticipating these future costs is doubtful.

- **Collective assessment – inconsistency with asset requirements**

According to BC 20 of the draft document, the allocation of shared costs to a group of obligations, which are collectively generated by them, is inappropriate as otherwise individual loss-making contracts could be concealed.

In this regard, we would like to point out that for asset impairment purposes group assessment is the general approach as the "Cash Generating Unit" (CGU) is the appropriate unit of account for testing. CGUs might further need to be combined to arrive at that unit, where cash inflows can be appropriately attributed. For corporate assets a similar approach is used.

If these principles were applied to costs (cash outflows) and provisions, costs should also be allocated and accounted for at that level, where they are clearly triggered and attributable. This could lead to a similar approach, where fixed cost/overheads could be taken into account on different levels where they are clearly caused.

- **Costs of cancellation indicate incremental basis**

IAS 37.68 defines “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” as the basis for the identification of an onerous contract. For a contract that can be terminated, penalty payments need to be taken into account and compared to the costs of fulfilling a contract. This indicates that the (original) approach uses an incremental approach to evaluate whether a contract is onerous. The proposed amendments would obviously extend the amount of costs to be considered and, therefore, could lead to a different accounting treatment depending on whether a contract can be terminated or not.

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.

AFRAC's response:

- **Costs according to IAS 37.68A c) and IAS 37.68B**

AFRAC agrees with the items listed in IAS 37.68A except for lit (c). IAS 37.68A (c) is broad and it is unclear how far the allocation should reach in practice. The same applies to "general and administrative costs" according to IAS 37.68B, e.g. for IT cost, management/board services, R&D costs and so on.

Cost accounting systems, -levels and -attributions vary from one company to another. The results depend on the configuration of the cost accounting systems and on the decision which levels of overheads/fixed costs are actually attributed or need to be attributed. Formulas for apportionment are often not generalizable. However, this is the essential question/task in the case at hand.

Based on the scope suggestions in BC 8+9 of the ED, the proposed changes should be applied to all kinds of contracts. It seems that the comparability addressed under BC 8+9 will be only achievable, if at least industry-specific examples/standards are made available. However, a general definition as part of a regulation based on general principles might not result in the desired outcome.

We are, therefore, concerned that supposed diversity in practice is not eliminated but shifted to a different level.

Question 3

Do you have any other comments on the proposed amendments?

AFRAC's response:

- **Scope: industries and purchase contracts:**

AFRAC notes that the IASB launched the project in response to a submission to the IFRS IC with the request to clarify the meaning of "unavoidable costs of meeting the obligation" for those contracts, which were previously in the scope of IAS 11 *Construction Contracts* and are now within the scope of IFRS 15 *Revenue from Contracts with Customers*. Until now discussions have been limited to certain industries, especially construction. The amendment proposes to extend the scope to a) all industries and b) purchase and other contracts. As far as we can see the impact on other industries and purchase contracts has not been analysed in detail. We encourage the IASB to assess further the impact of the proposed amendments on different industries and contracts taking into account similarities with and differences to other major accounting standards, e.g. US GAAP.

- **Unit of Account and other aspects:**

IAS 37.68 refers to the term "contract". As the discussion was triggered by the implementation of IFRS 15, the question arises, whether the appropriate unit of account is a single "performance obligation" rather than the whole contract.

While IFRS 15 focuses on single performance obligations for revenue recognition, we believe that the contract as a whole should be the unit of account for onerous contract accounting. In many cases the selling entity has a focus on the package as a whole rather than on single performance obligations, and may accept lower prices for single obligations, if the package as a whole is sufficient. The parties of a contract are committed to all performance obligations. Losses only arise if the whole commitment is onerous. If the single performance obligation was the unit of account, not only revenue but also cost would need to be allocated within the contract resulting in the same issue concerning the outflow side.

For the evaluation of purchase contracts the allocation of economic benefits is very important. The allocation of cost is, therefore, not the only relevant input for the accounting of onerous contracts. It would, therefore, make sense to evaluate all factors as part of the broader "provision" project.