

ACCOUNTING & FINANCE

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The accounting treatment under IFRS of provisions for onerous contracts with customers

According to IAS 37, provisions have to be created for onerous contracts with customers. Such a contract would be deemed to exist if the unavoidable costs of fulfilling the contract were higher than the expected economic benefits. In order to specify the scope of these costs, on 13.12.2018, the International Accounting Standards Board (IASB), in its Exposure Draft ED/2018/2 Onerous Contracts – Cost of Fulfilling a Contract, proposed appropriate amendments to IAS 37.

1. Reason

Examinations of practice by the IFRS Interpretations Committee had shown that there were different approaches to assessing whether or not a contract was onerous.

- » On the one hand, there were interpretations discernible under which all costs that related to the contract were included.
- » On the other hand, the concept of unavoidable costs was interpreted in such a way that solely incremental costs were taken into consideration, i.e. only those costs that would not be incurred without the contract.

2. Draft amendments to IAS 37

The draft amendments to IAS 37 made by the IASB now provide that all costs that directly affect the contract will be regarded as costs of fulfilling the contract. Thus, the incremental costs as well as other costs directly related to the contract will be taken into account.

Please note: There was a possibility to comment on ED/2018/2 up to 15.4.2019. On the basis of the comments received, the IASB should now be able to move forward with its proposal. The draft is available online at www.ifrs.org.

The following examples of costs that would relate directly to a contract are listed in the draft:

- » direct personnel costs (e.g. wages and salaries of those employees who undertake the manufacture or delivery or who provide a service directly to the customer);
- » direct material costs (e.g. supplies used in fulfilling the contract);

- » overhead expenses that relate directly to the contract activities (e.g. costs of contract management and supervision; insurance and depreciation of tools, equipment or rights-of-use assets used in fulfilling the contract);
- » costs explicitly chargeable to the customer under the contract;
- » other costs incurred only because the contract was concluded (e.g. payments to subcontractors).

By contrast, general administrative costs should only be taken into account if they are explicitly passed on to the customer.

3. Implications for accounting practice

If it has hitherto been assumed that solely incremental costs should be taken into account then the planned change would result in contracts with customers having to be classed as onerous at an earlier stage and, thus, the creation of a provision would be more likely.

In the opinion of the IASB, the amendments permit a more realistic representation of the fulfilment of a contract. Moreover, this is also consistent with the prevailing opinion in commentary literature in the German-speaking region according to which the full cost approach is deemed to be the only standard-compliant solution.

Conclusion

As expenses that are expected still to be incurred for pending transactions should generally, according to the Commercial Code (Handelsgesetzbuch, HGB), also be recognised at full cost (see German Accounting Standard of the Auditing and Accounting Board "IDW RS HFA 4"), this clarification is likely to lead to the alignment of the IFRS interpretation with that of HGB even if the concepts are not always identical.