

15 April 2019

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam

Re: Exposure Draft 2018/2 *Onerous Contracts – Cost of Fulfilling a Contract*

On behalf of the Institute of Public Accountants (IPA), I am writing to comment on Exposure Draft ED 2018/2 *Onerous Contracts – Costs of Fulfilling a Contract – Proposed amendments to IAS 37*.

The IPA does not believe it is necessary to amend IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as a result of IAS 11 *Construction Contracts* being superseded by IFRS *Revenue from Contracts with Customers*. We believe that the principles in IAS 37 for onerous contracts should continue to be applied unchanged.

The IPA is of the view the proposed definition of costs relating directly to the fulfilment including allocated costs will result in the capture as onerous contracts economically and commercially viable customer contracts.

There are commercial considerations that support the non-recovery of allocated costs and pricing on marginal or variable cost basis. The proposed approach is neither economically or commercially appropriate. The IPA believes that onerous contracts should be determined and provisions established based on the variable costs (i.e. the incremental cost approach in (BC16(a)) incurred to fulfil a contract.

Our detailed comments and responses to the questions in the Exposure Draft are set out in Appendix A.

If you would like to discuss our comments, please contact me or our technical advisers Mr Stephen La Greca (stephenlagreca@aol.com) or Mr Colin Parker (colin@gaap.com.au) (a former member of the AASB), GAAP Consulting.

Yours sincerely

Vicki Stylianou
Executive General Manager, Advocacy & Technical
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Cc Ms Kris Peach

About the IPA

The IPA is a professional organisation for accountants recognised for their practical, hands-on skills and a broad understanding of the total business environment. Representing more than 35,000 members in Australia and in over 65 countries, the IPA represents members and students working in industry, commerce, government, academia and private practice. Through representation on special interest groups, the IPA ensures the views of its members are voiced with government and key industry sectors and makes representations to Government including the Australian Tax Office (ATO), Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) on issues affecting our members, the profession and the public interest. The IPA recently merged with the Institute of Financial Accountants of the UK, making the new IPA Group the largest accounting body in the SMP/SME sector in the world.

APPENDIX A

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 costs of fulfilling the contract comprises the costs that relate directly the contract? If not, why not, and what alternatives do you propose?

IPA response

The IPA is of the view that the proposed amendments to IAS 37.68 do not reflect the economic and commercial reality of contract pricing nor are they consistent with the term “unavoidable costs”.

By defining unavoidable cost to include cost of fulfilling the contract including in the proposed IAS.37A under direct costs “allocations of costs that relate directly to contract activities (for example costs of contract management and supervision, insurance, depreciation of tools, equipment and right-to-use assets used in fulfilling the contract”) e.g. indirect costs, the IASB has ignored the commercial reality that entities enter into contracts with customers that may be priced on marginal costs basis when for example an entity has surplus capacity.

The fact that a contract does not recover all allocated (or fixed costs) does not make it an onerous contract. Rather, there are good commercial and economic reasons for entering into such contracts. As such, the IPA is of opinion the proposed changes to IAS 37.68 would result in including as onerous contracts commercially viable contracts entered into on a marginal costing basis.

In addition, the IPA is of view that allocated costs while arguably unavoidable are intrinsically of that nature as they fixed costs and will be incurred regardless, even where a contract is terminated early. As such, by including such costs in the cost of onerous contracts the IASB has in effect allowed the provisioning of future operating expenses which is implicitly contrary to IAS 37.61.

Question 2

The Board proposes to add paragraph 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.

IPA response

As noted in our response to Question 1, the IPA is of the view that the proposed IAS 37.68A by including allocated costs as direct costs of fulfilling a contract (proposed IAS 37.68(c)) the IASB in the determination of the costs of onerous contracts has ignored the commercial and economic reality of contracts entered into based on recovery of marginal or variable costs rather than on an absorption costing basis.

Furthermore, the IPA is concerned that the concept of direct costs is not applied consistently across all IASB standards. The following standards all deal use the term “direct costs”:

- IAS 2 *Inventories* – paragraphs 11 & 12
- IAS 16 *Property, Plant and Equipment* – paragraph 17, and

- IAS 38 *Intangible Assets* – paragraph 66.

The IPA believes the terminology should be consistent across standards. If specific costs that are not generally considered direct cost are applicable in the context of a particular standard they should be specifically identified and not included by using an alternative definition or example.

Finally, the IPA is concerned that the IASB literature is imprecise in the distinction between direct costs and indirect costs, and inconsistent with what would generally be considered direct costs from a management reporting perspective.

Question 3

Do you have any other comment on the proposed amendments?

IPA response

The IPA has no further comments.