STAFF PAPER

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IASB Meeting

Project	**Property, Plant and Equipment: Proceeds before Intended Use (Amendments to IAS 16)**
Paper topic	Feedback analysis

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Introduction and purpose

1. In June 2017, the International Accounting Standards Board (Board) published the Exposure Draft Property, Plant and Equipment—Proceeds before Intended Use (Exposure Draft). The Exposure Draft contains the Board's proposal to prohibit deducting from the cost of an item of property, plant and equipment (PPE) any proceeds from selling items produced while bringing that asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Instead, an entity would recognise those sales proceeds in profit or loss.

2. The comment period ended in October 2017. Many respondents to the Exposure Draft either disagreed with, or expressed concerns about, the proposed amendments. We provided the Board with a summary of the feedback in December 2017[1].

3. At that time, we advised the Board that we would:

   (a) undertake follow-up research with a number of respondents in order to:

      (i) clarify some of the matters raised in comment letters; and

      (ii) obtain a better understanding of some of the practical challenges identified.

[1] This summary of feedback is included in Agenda Paper 12D prepared for the December 2017 Board meeting.

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(b) provide an analysis of the feedback to the IFRS Interpretations Committee (Committee) to obtain its advice on the project. This is because the Board developed the proposed amendments in response to a request to the Committee.

4. The objective of this paper is to provide the Board with an analysis of the feedback on the Exposure Draft, considering both comment letters received and information obtained from our additional follow-up and outreach.

5. We provided an analysis of the feedback to the Committee and to the Accounting Standards Advisory Forum (ASAF) at their meetings in June and July 2018 respectively. Appendices A and B to Agenda Paper 12C include detailed feedback and advice on the possible project direction that we obtained from the Committee and from ASAF respectively.

6. In this paper, we are not asking the Board to make any decisions.

Structure of the paper

7. This paper is structured as follows:

   (a) background;

   (b) feedback overview; and

   (c) staff analysis.

Background

8. Paragraph 16(b) of IAS 16 *Property, Plant and Equipment* states that the cost of an item of PPE includes costs directly attributable to bringing that asset to the location and condition necessary for it to be capable of operating in the manner intended by management[2]. Paragraph 17 of IAS 16 specifies examples of directly attributable costs. Paragraph 17(e) identifies as one such example the cost of testing whether the

[2] For ease of reference, this paper uses the phrases 'available for use' or 'intended use' to describe the point in time at which an item of PPE is in the location and condition necessary for it to be capable of operating in the manner intended by management.

asset is functioning properly, after deducting the net proceeds from selling any items produced while making the asset available for use.

9. The Board developed the proposed amendments in response to a request to the Committee asking whether:

   (a) the proceeds specified in paragraph 17(e) of IAS 16 relate only to items produced from testing; and

   (b) an entity deducts from the cost of an item of PPE any proceeds that exceed the costs of testing.

10. The Committee’s work on the request indicated that entities apply diverse reporting methods in the treatment of proceeds before an asset is available for use, particularly in capital-intensive industries such as the extractive and petrochemical industries.

11. The proposed amendments to IAS 16 would prohibit deducting from the cost of an item of PPE any proceeds from selling items produced before the asset is available for use. Consequently, an entity would recognise such proceeds, together with the cost of producing those items, in profit or loss applying IFRS Standards.

12. The proposed amendments would also clarify the meaning of ‘testing’ in paragraph 17(e) of IAS 16—ie when testing whether an item of PPE is functioning properly, an entity assesses the technical and physical performance of the asset, and not its financial performance.

13. The Board proposed no specific disclosure requirements. In paragraphs BC24-26 of the Exposure Draft, the Board explained it expected the proceeds and their related costs to meet the definition of revenue and inventory respectively. Accordingly, the Board concluded that the requirements in IFRS 15 *Revenue from Contracts with Customers* and in IAS 2 *Inventories* would be sufficient to require an entity to disclose relevant information about the sale of output produced before an item of PPE is available for use.

14. The Board proposed that entities apply the amendments retrospectively to items of PPE made available for use on or after the beginning of the earliest period presented when an entity first applies the amendments.

Feedback overview

15. We received seventy-two comment letters that can be accessed here.

16. We also received preliminary feedback from ASAF and members of the Global Preparers Forum (GPF) in July and October 2017 respectively[3].

17. In order to obtain a better understanding of some of the matters raised in the comment letters, we conducted outreach with a number of stakeholders. We held discussions with:

    (a) regulators,

    (b) audit firms,

    (c) standard-setters,

    (d) preparers (including mining companies); and

    (e) two investors who follow the extractive industry.

18. We also considered feedback from past outreach activities when the Committee undertook research on this project, including feedback summarised in Agenda Paper 3C of the January 2015 Committee meeting.

Staff analysis

Recognition of proceeds and related costs in profit or loss

Board's view

18. The Board's view is that requiring an entity to recognise all proceeds, and any related costs, in profit or loss would result in the following improvements in financial reporting:

    (a) the current diversity in when, and the extent to which, entities deduct proceeds from the cost of an asset would be removed;

    (b) users of financial statements would have a clearer picture of:

[3] Appendices B and C to Agenda Paper 12D prepared for the December 2017 Board meeting include a summary of the feedback from those two consultative groups.

(i) the total cost of an item of PPE (and thus of the consumption of this asset in future reporting periods); and

(ii) an entity's total revenue (or income) for each period.

Main comments received

Improvements to financial reporting through the elimination of diversity in practice

19. Some stakeholders (including some preparers, regulators and one investor with whom we met) supported reporting the proceeds as revenue (or income) in profit or loss. They said this would improve financial reporting, in particular by removing diversity in reporting practices. For example, one respondent said:

> CPA Australia supports the proposed amendments to prohibit deducting any sales proceeds from the cost of developing an item of PPE. It is our view that the proposed amendments are likely to reduce the current diversity in practice when applying the relevant provisions of IAS 16 […]. [CPA Australia Ltd]

Another respondent said:

> Most members agree with the Board's proposal because they believe that the amendments to prohibit deducting proceeds from selling items produced from the cost of an item of PPE […] will reduce diversity and result in improved financial reporting. [IOSCO]

20. One investor with whom we met said the proposed amendments may improve reporting of information on revenue. However, this investor said that the proposed amendments might result in additional volatility in the statement of profit or loss and other comprehensive income of mining entities. In this investor's view, without sufficient knowledge of the amendments and of the volatility they might create, other investors might not fully appreciate and understand the reasons for any changes in some key metrics of mining entities.

Will the proposed amendments provide relevant information?

21. Some respondents to the Exposure Draft questioned whether the proposed amendments would provide relevant information.

22. Those respondents said the proposed amendments might result in entities recognising in profit or loss income and expenses from the sale of items before an item of PPE is available for use that may not be representative of sales (and related costs) after the

item of PPE is available for use. In particular, this is because the cost of items sold before the item of PPE is available for use excludes depreciation of that asset. Accordingly, the information derived from the statement of profit or loss and other comprehensive income with respect to the sale of these items may not have predictive value.

23. One investor shared this concern and said recognising in profit or loss the proceeds before an item of PPE is available for use may result in revenue (or income) that has little predictive value. In this investor's view, the inclusion of these sales proceeds in the income statement might not accurately reflect the performance of a mining entity since they are not representative of sales proceeds at normal production levels.

24. Those respondents who expressed concerns about predictive value also said the proposed amendments might result in additional volatility in the statement of profit or loss and in some key ratios—such as earnings per share. This was a particular concern for the mining companies with whom we met—they said the proposed amendments might encourage the increased use of non-GAAP measures.

25. The two investors with whom we met expressed concerns about how the proposed amendments may affect the computation of 'unit cash cost'[4] which is one of the key metrics that is used to measure and compare performance of mining entities.

Disclosure requirements as an alternative way to provide relevant information to the users of financial statements

26. Those who questioned whether the proposed amendments would provide relevant information suggested the Board not change the existing measurement requirements in IAS 16 and, instead, require specific disclosures—in particular disclosures about the amount of proceeds credited against the cost of PPE.

27. Both investors said the disclosure of this information would be useful. One of these investors said that such disclosures would be more useful if entities disclosed the information at a segment or at a project level. This investor also said disclosure at a

[4] This is a non-GAAP measure which has in practice many variations. In general, it is computed as the ratio of (i) direct cash costs incurred throughout the extractive process plus royalties paid, less any sales of by-products and (ii) the output produced.

project level of the amount of capital expenditures incurred during a particular financial reporting period would also be useful information.

28. The entities with whom we discussed this said that information about the amount of sales proceeds credited against the cost of PPE would not be difficult to provide.

Are proceeds before intended use sufficiently material to justify amending the existing requirements?

29. Some respondents said the matter the Board wishes to address with the proposed amendments is not material for many industries. Those respondents who commented on the applicability of the amendments to the extractive industry said that proceeds before intended use are material for entities operating in this industry only.

Staff analysis

Consistency of the proposed amendments with the Conceptual Framework for Financial Reporting

30. In March 2018, the Board issued the revised *Conceptual Framework for Financial Reporting* (Framework). Paragraph 4.68 of the Framework includes the following definition:

> Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

31. In our view, the proceeds from selling items produced before an item of PPE is available for use meet the definition of income in the Framework. This income reflects an entity's performance. Therefore, an entity would recognise such income in profit or loss, unless the Board requires otherwise.

32. Accordingly, we think the proposed amendments are consistent with the concepts included in the Framework and, thus, provide useful information, ie information that is relevant and represents faithfully what it purports to represent.

The relevance of financial information

33. We understand that the proceeds earned before an item of PPE is available for use may have little predictive value in relation to the future cash flows that an entity will derive from an asset once this asset is available for use. We would expect the quantities, and often the nature, of items sold before an item of PPE is available for

use to be very different from those sold after the asset is available for use. However, we think the recognition of income and related expenses in profit or loss reflects an entity's performance and has confirmatory value.

Presentation and disclosure requirements

34. Based on the feedback, the Board might, at a minimum, reconsider whether specific presentation or disclosure requirements are necessary to enable users of financial statements to identify such proceeds and their related costs. Those requirements may help address concerns about the limited predictive value of proceeds before an asset is available for use.

35. We think that presentation or disclosure requirements would be particularly important for 'junior' mining entities—ie entities operating few extractive projects. The proposed amendments for such entities could materially affect their financial statements. This is because:

    (a) applying the existing requirements in IAS 16, we understand that those entities generally do not report any amounts of revenue (or income) before the commercial phase of a mine begins—ie those entities generally credit sales proceeds earned during the development phase of a mine against the cost of the mine.

    (b) applying the proposed amendments, those entities would recognise in profit or loss the proceeds and costs from selling items before the commercial phase begins and, thus, might report profitable results during that development phase. Such entities might ultimately be unable to achieve a significant level of production from the particular extractive projects. Accordingly, without additional information, the users of financial statements may not reasonably be able to use this information to assess the entity's future performance.

36. We considered the possible actions that Board might undertake in relation to presentation and disclosure requirements in Agenda Paper 12C as part of our discussion on the possible ways to move forward with the project.

Cost allocation

Board's view

37. In recognising sales proceeds in profit or loss, the Board observed in paragraph BC7(a) of the Exposure Draft that an entity would have to identify costs that relate to items produced and sold before an item of PPE is available for use. The proposed amendments would therefore require any such costs to be distinguished from other costs incurred before an item of PPE is available for use—in particular, costs directly attributable to making an item of PPE available for use, which the entity includes in the cost of the asset[5]. In paragraph BC8 of the Exposure Draft, the Board noted that the proposed amendments would require little more judgement beyond that already required to apply IFRS Standards—in particular the requirements in IAS 16, IAS 2 and IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine*.

Main comments received

38. Many respondents disagreed with the Board's observations above. We identified three broad categories of interrelated concerns.

Practical challenges

39. Some respondents said it is practically difficult to identify costs that relate to items produced and sold before an item of PPE is available for use and distinguish them from other costs.

40. Some respondents mentioned significant challenges for entities operating in the extractive industry. This is mainly because of the nature and magnitude of operations in that industry. For example :

    (a) one respondent indicated that an extractive entity might have as many as 5,000 cost inputs to produce inventory, most of them being indirect costs.

    (b) a number of activities may be undertaken in constructing a mine (for example, removal of waste, trial mining, commissioning and ramp-up) as it progresses through the various stages in its life cycle from prospecting to reclamation. Depending on the size of the mine, different geographical

[5] This paper refers to the identification of costs that relate to items produced before an item of PPE is available for use as 'cost allocation'.

areas of the mine may be at different stages of development or production. This means the allocation of costs between sales proceeds and the cost of PPE may vary in different parts of the mine thereby potentially making the cost allocation process more complex than in other industries.

41. Conversely, some respondents agreed with the Board's observation that the proposed amendments would not result in a significant level of additional judgement beyond that already required in applying IFRS Standards. For example, an organisation of preparers with whom we discussed the matter confirmed that entities usually have much experience with cost allocation and, thus, that the proposed amendments should not result in specific implementation difficulties for many industries.

Use of judgement

42. Some respondents said the proposed amendments might require extensive use of judgement—in particular, to allocate indirect costs in circumstances in which an entity would not have reliable data on the 'normal capacity' of an item of PPE.

Diversity in the reporting of costs

43. Some respondents mentioned the potential diversity in the reporting of costs that might result from the proposed amendments. This is because the proposed amendments do not include any principle or application guidance in relation to cost allocation. Those respondents said a variety of different approaches may evolve, each resulting in a different reflection of financial performance—in particular, for the extractive industry. For example, one respondent said:

> For many entities, particularly in the extractive industries, the proposed changes will have a material impact on reported results, but will not in our view improve reporting or reduce diversity in practice, principally because of the lack of clear guidance on the allocation of costs against the proceeds in the income statement. [Anglo American plc]

44. One investor with whom we met expressed concerns on this potential diversity. This investor suggested that if the Board decides to proceed with the amendments then the Board also require disclosure on the particular methodology that an entity applies to perform such a cost allocation.

45. One respondent said the proposed amendments would not reduce the existing diversity in the reporting of costs across the extractive industry. This respondent noted that:

> The proposals made in the Exposure Draft would have a very significant impact on entities in the extractive industries. We do not consider that this would be desirable, as diversity in reporting on issues such as which costs are capitalised and when capitalisation ceases would remain. This highlights the need for a comprehensive project on extractive industries. A narrow amendment targeted only at proceeds received during testing would pre-judge the outcome of that project. [FRC]

46. In the light of the concerns described above, many respondents said the Board should, as a minimum, set out a cost allocation principle or suggested the Board should provide application guidance or examples. A few of those respondents identified methods of cost allocation that may assist entities in applying the proposed amendments. Those approaches consisted in allocating to items produced before an item of PPE is available for use:

(a) a cost equal to the proceeds earned,

(b) no cost at all,

(c) an incremental cost, or

(d) a standard or expected cost (excluding depreciation).

Staff analysis

Practical challenges

47. In our view, the concerns that many respondents raised about cost allocation relate to the broader issue of the allocation of 'joint costs', ie the costs of a production process yielding different types of output at the same time. In particular, joint costs arise when:

(a) a process produces joint products or by-products[6]. We understand that joint products and by-products are quite common for many entities—including

[6] In practice, we understand that joint products are products that have more than an insignificant selling price while by-products have an insignificant selling price (in this case, it is common to refer to the main product and the related by-product).

those operating in the extractive industry. Paragraph 14 of IAS 2 specifies cost allocation requirements for such items.

(b) sales proceeds arising from incidental operations—ie operations that occur in connection with the construction or development of an item of PPE but that are not necessary to make the asset available for use. Paragraph 21 of IAS 16 requires such proceeds (and their related expenses) to be recognised in profit or loss.

48. In light of the circumstances identified above, we think the proposed amendments do not create new practical challenges from a cost accounting perspective. We note that, in those circumstances, entities have already applied judgement in determining a cost allocation methodology that is rational and consistent. Stakeholders have not reported specific application difficulties in those circumstances. Accordingly, we think entities could consider their experience in allocating joint costs when applying the proposed amendments.

49. In addition, the comment letters and our additional research confirmed that the proposed amendments are unlikely to affect most industries because sales proceeds before intended use are typically not material for entities in those industries.

50. A number of entities affected by the proposed amendments also said:

(a) they have cost allocation systems such as ERPs (Enterprise Resources Planning systems) in place that are capable of implementing the changes arising from the proposed amendments. However, we are aware that some junior mining entities may have less sophisticated systems than major entities operating in this industry and so the proposed amendments might add an additional level of complexity in their approach to allocating costs.

(b) they could make the necessary judgements, using their experience on cost allocation.

51. Nonetheless, we acknowledge the existence of practical challenges for the extractive industry. In particular, this is because:

(a) the complexity of operations in this industry makes the scale of cost allocation bigger than for other industries.

(b) operationalising the proposed amendments might result in additional implementation costs. As noted in one comment letter and during outreach, the proposed amendments would require an analysis of direct and indirect costs incurred before an item of PPE is available for use—thereby requiring the tracking of some costs at a more granular level. For example, an entity might need to apportion the costs of development teams testing an item of PPE between (i) the cost of items sold and (ii) the cost to be capitalised as part of the asset. This would require tracking of hours spent by those teams. At present, entities do not need to monitor those hours, except for abnormal costs.

Use of judgement

52. We acknowledge that the proposed amendments would require entities to apply judgement to a new area of cost allocation. In particular, we understand that allocating costs while an item of PPE is being constructed—ie when production is not yet stable—may not be as straightforward as when such an asset is available for use.

53. However, we think the judgement involved is not substantially different from judgements already required in applying other IFRS Standards—for example, applying IAS 2 in allocating production overheads to compute the costs of conversion of inventory.

Diversity in the reporting of costs

54. We acknowledge respondents' concerns and see benefit in the Board considering the inclusion of a principle and/or requirements on cost allocation. We considered the possible actions that the Board might undertake in relation to cost allocation in Agenda Paper 12C as part of our discussion on the possible project direction.

55. Some respondents expressed particular concerns that the potential diversity in cost allocation methodologies might result in the potential loss of comparability among entities operating in this industry.

56. Nonetheless, we note that:

(a) many entities operating in the extractive industry apply the requirements in IFRS 6 *Exploration for and Evaluation of Mineral Resources*, which permits various accounting practices in relation to many aspects of the recognition, measurement and presentation of exploration and evaluation assets. Those assets often represent material balances in the statement of financial position of entities operating in the extractive industry.

(b) one investor with whom we met has observed diversity in reporting practices in relation to the accounting of costs incurred during the development phase of a mine.

(c) some mining entities said that sales proceeds are often not material at a group level, although they are likely to be material for some segments.

Available for use

Board's view

57. As explained in paragraphs BC18-22 of the Exposure Draft, the Board considered clarifying when an item of PPE is available for use as a possible approach to reduce the identified diversity in the reporting of sales proceeds. In particular, paragraph BC20[7] of the Exposure Draft includes the indicators of when an item of PPE is available for use that the Board considered including in IAS 16.

58. In its deliberations, the Board concluded that such an approach:

(a) would be a much broader project than the proposed amendments would be; and

(b) would not have removed the existing need to apply judgement in determining when an item of PPE is available for use.

[7] Paragraph BC20 of the Exposure Draft states: '[…] The Board considered whether to amend IAS 16 to include the following as indicators of when an item of PPE is available for use:

(a) the physical construction of the asset is complete (as described in paragraph 23 of IAS 23 *Borrowing Costs*).

(b) the testing of the technical and physical performance of the asset is complete […].

(c) the asset is capable of producing items that can be sold in the ordinary course of business (ie capable of producing inventories as defined in IAS 2). Consistent with the meaning of testing, this assessment would focus on the technical and physical performance of the asset, and not its financial performance.

Main comments received

59. Many respondents said that clarifying the requirements on when an item of PPE is available for use is fundamental to resolving the issue the Board is trying to address through the proposed amendments.

60. Some of those respondents said entities have differing interpretations of when an item of PPE is available for use. For example, one respondent said:

> While we understand the Board's rationale for deciding not to clarify when an item of PPE is ready for its intended use, we believe that this issue is of sufficient importance to warrant a broader project. In this context, we note that the practice for determining when an asset is available for its intended use varies significantly between industries and countries, which exacerbates the accounting concerns about the treatment of proceeds before an asset is ready for its intended use. [EY]

61. One respondent said that clarifying when an item of PPE is available for use was one of several substantive questions that the Board should further examine before proceeding with the proposals. This respondent said:

> … The [ED] might put more pressure on the identification of when an item of PPE is ready for its intended use […]. However, as noted in paragraph BC22 of the Exposure Draft, the IASB indicated that providing […] guidance [on when an item of PPE is available for use] would be a much broader project than the proposed amendments. EFRAG also notes that the IASB did not proceed with such a project as it would have affected the accounting for many items of PPE and additional research would have been required to assess any potential unintended consequences. In our view, such research is necessary in order to justify the proposed amendments to IAS 16. [EFRAG]

62. However, almost none of those respondents provided suggestions on how to clarify the existing requirements in IAS 16. In particular, respondents did not comment on the indicators of available for use set out in paragraph BC20 of the Exposure Draft.

Staff analysis

What is creating differing interpretations of available for use?

63. During our outreach, several respondents indicated that entities interpret differently the phrase in paragraph 20 of IAS 16 'to be in the location and condition necessary for

[an item of PPE] to be capable of operating in the manner intended by management'. More precisely, some said:

(a) 'to be in the location and condition necessary for [an item of PPE] to be capable of operating' implies a technical and physical assessment of the item of PPE; however

(b) 'in the manner intended by management' might imply that an entity could also assess the financial performance of the item of PPE.

64. Some other respondents said distinguishing a physical assessment of an asset and an assessment of its financial performance is difficult in some circumstances. For example, an entity may consider that an item of PPE is available for use when it is capable of producing a specified percentage of its 'normal' capacity over a specified period of time. This percentage can be set in such a way that, when the percentage is achieved, the asset is operating at more than break-even. In this case, some said it is unclear whether such an assessment is technical or financial.

65. A few respondents supported the Board's proposed definition of testing activities set out in paragraph 17(e) of the proposed amendments and explained further in paragraph BC10 of the Exposure Draft. This definition states that testing activities relate only to the technical and physical performance of an item of PPE. However, those respondents were not convinced this definition would effectively remove uncertainties about the date on which an item of PPE is available for use—in particular the uncertainty described in paragraph 63 of this paper.

66. The investors with whom we met said little information is typically available on the assessment that mining companies make of when a mine is available for use. Those investors said improving disclosure about this judgement—which is often material for mining companies—would be helpful.

Requirements included in US GAAP

67. During our outreach, a few respondents suggested that the Board consider the definition of 'intended use'[8] in US GAAP requirements. This definition puts

[8] The notion of 'intended use' in US GAAP is similar to the notion of 'available for use' in IAS 16. Topic 835––*Interest* refers to 'intended use' which is defined as follows: 'intended use of an asset embraces both readiness for use and readiness for sale, depending on the purpose of acquisition'.

emphasis on the physical assessment of an item of PPE. In those respondents' view, this definition:

(a) enables preparers to apply their judgement in a more consistent manner.

(b) results in US GAAP entities generally having no material proceeds from the sale of items produced before an item of PPE is ready for its 'intended use'.

68. Those respondents noted specific industry guidance in US GAAP for extractive entities, which clarifies when depreciation of a mine starts—ie when the production phase starts. In particular, Topic 930 *Extractive Activities – Mining* defines the 'production phase' as follows:

> The production phase of a mine is deemed to begin when saleable minerals are extracted (produced) from an ore body, regardless of the level of production. However, the production phase does not commence with the removal of de minimis saleable mineral material that occurs in conjunction with the removal of overburden or waste material for the purpose of obtaining access to an ore body.

Staff view

69. In our view, the indicators of when an asset is available for use included in paragraph BC20 of the Exposure Draft could potentially address some (but not all) stakeholders' concerns. We also note they would align the requirements in IAS 16 on available for use with those in IAS 23 *Borrowing Costs* on when capitalisation of interest ceases.

70. In addition, based on the feedback received, we think those indicators would result in 'available for use' in IAS 16 being described similarly to 'intended use' in US GAAP.

71. However, as explained in paragraph 62 above, respondents did not comment on those indicators, so it is unclear whether they assessed those indicators as useful.

72. Were the Board to reconsider the approach of clarifying when an asset is available for use, we think we would need to gather further evidence of the significance of the matter and obtain further feedback on the possible standard setting solutions. We note that, at present, we do not have such evidence, other than the comments received in the comment letters responding to this Exposure Draft. We also note that respondents to the *2015 Agenda Consultation* did not specifically refer to this matter as a suggestion for a possible additional project to be added to the Board's work plan.

Exclusion of depreciation

Board's view

73. The Board observed in paragraph BC11 of the Exposure Draft that before an item of PPE is available for use, the costs of producing items sold excludes depreciation of that asset. This is because depreciation of an asset begins when it is available for use. In the Board's view, any consumption of an item of PPE before it is available for use is likely to be negligible.

Main comments received

74. Many respondents expressed concerns about excluding depreciation from the cost of items produced before an item of PPE is available for use. In particular, they disagreed with the Board's observation in paragraph BC7 of the Exposure Draft that the cost of items produced before an item of PPE is available for use excludes the depreciation of that asset.

75. Some of those respondents also disagreed with the Board's observation that any consumption of an item of PPE before it is available for use is likely to be negligible. For example, one respondent said:

> Paragraph BC11 in the Basis for Conclusions states that depreciation should be excluded from the cost of selling items produced before the asset is available for use on the assumption that these costs are 'negligible'. We do not believe that this is an appropriate assumption in all instances as the testing period may be quite long and such costs could be significant. [CPA Canada]

Staff analysis

76. Paragraph 55 of IAS 16 states:

> Depreciation of an asset begins when it is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

77. Accordingly, the Board's observation in BC11 of the Exposure Draft reflects the requirements in IAS 16.

78. IAS 16 assumes that the consumption of the expected future economic benefits embodied in an item of PPE starts when the asset is available for use. In our view, if

an entity were to assess that the consumption of an item of PPE is more than negligible during its construction or development, then this would indicate that the asset is already available for use (ie already in the location and condition necessary for it to be capable of operating in the manner intended by management). Accordingly, we continue to agree with the Board's observation that any consumption of an item of PPE before it is available for use is likely to be negligible.

Assessment of 'ordinary' activities

Board's view

79. The Board observed in paragraph BC24 of the Exposure Draft that if the item of PPE under construction is to be used in the entity's ordinary activities, there is no basis on which to conclude that inventories produced by the asset before it is available for use would not be output from the entity's ordinary activities.

Main comments received

80. Many respondents disagreed with the Board's assessment that sales proceeds before an item of PPE is available for use would typically arise from an entity's ordinary activities. For some respondents, if those items are not part of an entity's ordinary activities, that would support retaining the existing requirements in IAS 16 of crediting the sales proceeds against the cost of an item of PPE.

Staff analysis

81. We note that the Board's observation to which some respondents referred is included in the Basis for Conclusion on the Exposure Draft. Accordingly, the Board intended neither to override management's assessment of ordinary activities nor specify requirements in this respect. The Board's observation in paragraph BC24 of the Exposure Draft was included as an explanation of the Board's decisions regarding disclosure requirements.

82. We also note that paragraph 20A of the proposed amendments requires the proceeds and related costs be recognised in profit or loss 'in accordance with applicable Standards'.

83. If an entity were to assess that the proceeds relate to items that are *not* output of its ordinary activities, those proceeds and their related production costs would not be

within the scope of IFRS 15 (ie the proceeds would not meet the definition of revenue) or IAS 2 respectively. However, they would still meet the definitions of income and expense as defined in paragraphs 4.68 and 4.69 of the Framework. Accordingly, we think an entity would recognise them in profit or loss, regardless of the fact they do not arise from an entity's ordinary activities.

84. We think the Board may need to consider further the possible implications on presentation and disclosure of an entity assessing that sales proceeds before an item of PPE is available for use are not part of its ordinary activities. In those circumstances, the disclosure requirements in IFRS 15 and IAS 2 might not apply to the proceeds and related production costs. As explained in paragraphs 34-35 above, disclosure of the amount and treatment of sales proceeds before an item of PPE is available for use may be important for users of financial statements.

Interaction with other Standards

Interaction with the requirements in IAS 23

Main comments received

85. Some respondents supported the alternative view expressed in paragraph AV6 of the Exposure Draft stating that the proposed amendments would be inconsistent with IAS 23.

86. In particular, those respondents supported retaining the existing requirements in paragraph 17(e) of IAS 16 on the basis that crediting against the cost of an item of PPE sales proceeds before this item of PPE is available for use is, in their view, consistent with the requirements in paragraph 12 of IAS 23.

Staff analysis

87. Paragraph 12 of IAS 23 paragraph states (emphasis added):

> To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as **the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings**.

88. Paragraph 13 of IAS 23 goes on to state (emphasis added):

> The financing arrangements for a qualifying asset may result in **an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset**. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, **any investment income earned on such funds is deducted from the borrowing costs incurred**.

89. The requirements in paragraphs 12-13 of IAS 23 apply when an entity borrows funds and does not use them immediately for the acquisition, construction and production of a qualifying asset. The entity might temporarily invest those funds, earning interest income, before using them to obtain a qualifying asset.

90. In our view, those requirements are a way of preventing the capitalisation of borrowing costs that do not relate to the qualifying asset—those requirements ensure that an entity capitalises only borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. Accordingly, in our view the requirements in IAS 23 do not conflict with the proposed amendments.

Requirements in IAS 16 and IAS 2 on 'abnormal' costs'

Main comments received

91. The Board noted in paragraph BC8 of the Exposure Draft that an entity is required by IAS 2 and IAS 16 to recognise particular abnormal costs as expenses in the period in which they are incurred—these include abnormal amounts of wasted materials, labour or other costs of producing inventory or self-constructing an item of PPE.

92. Some respondents suggested that an entity should capitalise such costs related to self-constructing an item of PPE because they are necessary to make the asset available for use.

93. Some mining entities also said that they are already facing challenges on the identification of abnormal costs and, that the proposed amendments would increase the severity of those challenges.

94. A few respondents asked for clarification of the nature of abnormal costs.

Staff analysis

95. In paragraph BC8 of the Exposure Draft, the Board outlined the existing requirements in IAS 2 and IAS 16 in explaining its decision regarding cost allocation. We think it is beyond the scope of the project to reconsider those requirements on abnormal costs.

Interaction with the requirements in IFRS 6

Main comments received

96. A few respondents asked the Board to clarify whether the proposed amendments would also apply to assets within the scope of IFRS 6.

Staff analysis

97. We understand that, in applying IFRS 6, some entities have credited sales proceeds against the cost of exploration and evaluation assets. If the Board proceeds with the proposed amendments, then we think it should also propose a similar amendment to IFRS 6, including the transition requirements.

Question for the Board

Do Board members have any questions or comments on our analysis set out in paragraphs 18-97 of this paper?