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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**21 June 2007, London**
Project:	**Annual improvements**
Subject:	**Sale of assets held for rental (Agenda paper 12B)**

Background

1. The IFRIC was asked to provide guidance on the accounting for sales of assets held for rental. In various industries - such as car rental, aircraft manufacturing, heavy equipment, shipping, property industry - some entities sell assets after renting them out to third parties under an operating lease. In such circumstances, it appears that the asset is manufactured or acquired with a dual intention, to be rented out and to be sold.
2. For assets held for rental to others that are expected to be rented for more than one period, the issues are:
   - whether their sale should be presented gross (revenue and costs of sales) or net (gain or loss) in the income statement; and
   - how should they be classified in the balance sheet during the renting period and the held for sale period (if any).
3. The staff found that diversity arises in terms of presentation in financial statements. This diversity is geographically widespread in at least two industries:

car rental and automotive manufacturing. For instance, in the car rental industry, some argue that companies in this industry are in the business of renting cars and selling second-hand cars ("dual intention"[1]). Usually, these companies have the infrastructure in place to sell the second-hand cars (e.g. a separate sales department). Sales of second-hand cars effectively form part of the trading activities, are recurrent and generate significant cash inflows. Therefore, they are presented as revenue in the income statement. On the other hand, those who recognise only a net gain or loss on disposal of second-hand cars argue that they strictly apply IAS 16 *Property, Plant and Equipment* paragraph 68.

4. At its May 2007 meeting, the IFRIC noted that IAS 16 paragraph 68 states that gains arising from derecognition of an item of property, plant and equipment shall not be classified as revenue. Also, when the asset is classified as held for sale under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, IFRS 5 paragraph 24 refers to the derecognition requirements of paragraphs 67-72 of IAS 16, thereby confirming that gains should not be classified as revenue. However, some of the IFRIC believed that, in some circumstances, reporting gross revenue in the income statement would be consistent with the *Framework* paragraph 72, with IAS 18 *Revenue*, IAS 2 *Inventories*, and IAS 40 *Investment Properties* and with the prohibition on offsets in IAS 1 *Presentation of Financial Statements*.

5. As IAS 16 is clear that disposal of an item of PP&E should be reported net in the income statement, the IFRIC believed that this issue would be better addressed by amending the Standards rather than by the means of an Interpretation. Therefore, the IFRIC decided not to take the issue on to its own agenda and to draw the issue to the attention of the Board.

[1] Term used in the submission to the IFRIC

Staff analysis

6. Based on the discussion at IFRIC meetings, the staff present to the Board the two possible alternative views:

   - View 1: when sales of assets held for rental arise in the course of an entity's ordinary activities and recur on a regular basis, the entity should report gross revenue from these sales;
   - View 2: revenue from the sales of these assets should be reported net. No exception should be made to IAS 16.

View 1 – Presentation of gross revenue

7. Supporters of view 1 believe that an entity should report gross revenue from sales of assets held for rental to others when, and only when, these sales arise in the course of the ordinary activities and recur on a regular basis. Therefore, the entity would recognise revenue arising from both renting and selling. This gross presentation would enhance financial statements as it would reflect better the nature of activities of the entity (both renting and selling). The operating margin would take into account a significant and recurrent part of revenue.

8. Two possible accounting treatments would reflect that gross presentation of revenue:

   - View 1A:
     - The asset is initially classified as **non-current PP&E**. IAS 16 specifically includes tangible items that are held for rental to others and the fact that the asset is expected to be sold should not be taken into account at initial classification,
     - When the asset ceases to be rented, either it is immediately sold and gives rise to revenue or it is held for sale and transferred to inventories.
   - View 1B:
     - The asset is initially classified as **current inventories**. IAS 2 defines inventories as assets held for sale in the ordinary course of business. In the context of this issue, the operating

cycle of the entity, e.g. a car rental company, is the time between the acquisition of the asset and its sale, therefore including the rental period.

9. Supporters of view 1 believe that the notion “in the course of the ordinary activities” plays an important role in IFRSs and the Framework and note the following:

   - the *Framework* paragraph 72, which states that:

     “Income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making. For example, it is common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the entity and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the entity to generate cash and cash equivalents in the future; for example, incidental activities such as the disposal of a long-term investment are unlikely to recur on a regular basis. When distinguishing between items in this way consideration needs to be given to the nature of the entity and its operations. Items that arise from the ordinary activities of one entity may be unusual in respect of another.”

   - IAS 18 *Revenue* paragraph 7, which defines revenue as “the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when […]”.

   - IAS 2 *Inventories* paragraph 6 (a), which defines inventories as assets held for sale in the ordinary course of business.

10. Supporters of view 1 also note the prohibition on offsets in IAS 1 *Presentation of Financial Statements* paragraphs 32 to 35.

11. Supporters of view 1A also follow the rationale of :

   - BC35 of IAS 16, which explains clearly the Board’s reasoning underpinning the requirements of paragraph 68 of that Standard:

     “Although the Board concluded that an entity should apply the recognition principle for revenue from sales of goods to its recognition of gains on disposals of items of property, plant and equipment, the Board concluded that the respective approaches to income statement display should differ. <u>The Board concluded that users of financial statements would consider these gains and the proceeds from an entity's sale of goods in the course of its ordinary activities differently in their evaluation of an entity's past results and their projections of future cash flows. This is because revenue from the sale of goods is typically more likely to recur in comparable amounts than are gains from sales of items of property, plant and equipment</u>. Accordingly, the

Board concluded that an entity should not classify as revenue gains on disposals of items of property, plant and equipment."

- IAS 40 *Investment Properties* deals with transfers to and from investment property classification (paragraphs 57 to 65) and disposals (paragraphs 66 to 73). In contrast, IAS 16 deals with derecognition (on disposal or when no future economic benefits are expected) but remains silent on transfers. In particular, IAS 40 paragraph 58 illustrates a case of change in use of an asset and the possible transfer from investment property to inventories that will give rise to revenue recognition:

  "Paragraph 57(b) requires an entity to transfer a property from investment property to inventories when, and only when, there is a change in use, evidenced by commencement of development with a view to sale. When an entity decides to dispose of an investment property without development, it continues to treat the property as an investment property until it is derecognised (eliminated from the balance sheet) and does not treat it as inventory".

12. Under view 1A, the Board may also consider that, in addition to rental and sale of rental assets being ordinary activities of the entity, further conditions should be met to present revenue gross, for instance:

    - The business model of the entity relies on leasing and selling the assets,
    - A structure is in place to facilitate these sales, and
    - An active market exists for the second-hand assets.

13. Finally, depending on the initial classification, that is, either PP&E (view 1A) or inventories (view 1B), the effect on measurement should be considered. For instance, under view 1A, if an entity chooses the cost model of IAS 16, the entity would usually depreciate the depreciable amount of the asset on a straight-line basis over the rental period. Instead, under view 1B, the asset classified as inventory would, as a whole, be stated at the lower of cost and net realisable value at each period.

View 2 – Presentation of net revenue

14. Supporters of view 2 believe that an entity should report net revenue from sales of assets held for rental to others. They believe that many assets have a significant residual value relative to their cost and are ultimately disposed of. They believe it is difficult to draw a clear dividing line between transactions in the course of the ordinary activities and those that are not. Finally, they believe that adopting view 1 could lead to overstatement of revenue.

15. Supporters of view 2 maintain that IAS 16 is clear that gains arising from derecognition of an item of property, plant and equipment shall not be classified as revenue and that no exception should be made.

Staff recommendation

16. The staff support view 1 because it believe that some entities are in the business of both renting and selling the same asset and that the nature of this asset is different from other PP&E. The staff believe that, when sales of assets held for rental arise in the ordinary course of an entity's activities and recur regularly, the entity should report gross revenue from the sale of such asset, as well as gross revenue from the rent. This rationale is consistent with the Framework and other Standards. The financial reporting of entities dealing with both activities (renting and selling the asset) would be enhanced as revenue would reflect their ordinary activities. In addition, the staff support view 1A because, similar to IAS 40, a transfer from PP&E to inventories would reflect better the change in use of the asset than merely an initial classification as inventories (view 1B).

17. The staff do not support view 2 because it would mean ignoring the fact that some entities are renting out and selling the same asset in the course of their ordinary activities and would lead to recognition of revenue only from renting activities whereas selling activities are recognised net in the income statement.

18. The staff ask Board members the following questions:

(a) Do Board members agree with the staff recommendation (view 1A)?

(b) If so, do you agree with proposed amendments to IAS 16 set out in the appendix of this paper?

(c) If the Board members do not agree with the staff recommendation, do they believe rental assets should be classified as current inventories (view 1B)?

(d) If so, the staff will consider whether amendments are required to IAS 16 and IAS 2 and bring a paper to a future Board meeting.

(e) If Board members do not agree with either view 1A or view 1B, do they believe that paragraph 68 and BC 35 of IAS 16 are clear (view 2)? Or should accounting for the sale of rental assets be considered as part of the revenue recognition project?

Appendix: drafting reflecting view 1A

Derecognition

…

68 The gain or loss arising from the derecognition of an item of property, plant and equipment shall be included in profit or loss when the item is derecognised (unless IAS 17 requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.

68A However, an entity that, in the course of its ordinary activities, regularly sells property, plant and equipment that it has held for rental to others shall reclassify such property, plant and equipment to inventories when it ceases to be rented and is held for sale. The proceeds from the sale of such assets shall be recognised as revenue in the income statement.

Basis for Conclusions on Proposed Amendments to IAS 16 *Property, Plant and Equipement*

This Basis for Conclusions accompanies, but is not part of, the draft amendments.

Assets held for rental to others

BC1 The Board has identified that, in some industries, entities are in the business of renting and selling the same asset.

BC2 The Board noted that IAS 16 prohibits the classification of sales of property, plant and equipment as revenue, and requires recognition of the gain or loss arising on derecognition of an item of property, plant and equipment. The Board also noted that the Basis for Conclusions on IAS 16 (paragraph BC35) states the reason for this as "users of financial statements would consider these gains and the proceeds from an entity's sale of good in the course of its ordinary activities differently in their evaluation of an entity's past results and their projections of future cash flows".

BC3 Consistent with that, the Board concluded that entities whose ordinary activities include renting and selling the same assets should recognise revenue from both renting and selling the assets. In the Board's view the recognition of selling revenue gross, rather than a net gain or loss on sale of the assets, would better reflect the ordinary activities of such entities.