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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**Wednesday 20 February 2008, London**
Project:	**ED Annual improvements process–Comment analysis**
Subject:	**Q10 – Sale of assets held for rental (Agenda paper 4F)**

Background

1. The Board identified that in some industries, such as car rental, aircraft manufacturing, heavy equipment and shipping, entities are in the business of renting and subsequently selling the same asset. 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. The Board noted that IAS 16 *Property, Plant and Equipment* prohibits classification as revenue of gains arising from derecognition of items 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 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.'

3. In the ED, the Board proposed to add paragraph 68A to IAS 16.

   68A However, an entity that, in the course of its ordinary activities, routinely sells items of property, plant and equipment that it has held for rental to others shall transfer such assets to inventories at their carrying amount when they cease to be rented and are held for sale. The proceeds from the sale of such assets shall be recognised as revenue in accordance with IAS 18 *Revenue*.

Staff analysis

4. The Board received 75 comment letters with the following breakdown:

Yes:	32
Yes, but expressed concern:	17
No:	8
No answer given:	18
Total:	75

5. The staff noted that the majority of respondents agreed with the proposed amendment or had no objection. Those who agreed argued that the presentation of gross selling revenue, rather than a net gain or loss on the sale of the assets, would better reflect the ordinary activities of such entities.

6. However, some respondents expressed concern with the proposal. They expressed mixed views that are reflected below.

A) Set out a principle-based approach within a larger project

7. If restricted to PPE held for rental, some respondents[1] claimed that the proposed amendment appears to be rule-driven and asked the Board to develop a principle-based approach that applies to all sorts of PPE, regardless of their initial use. Some of them believed the issue should be dealt with in the revenue recognition project or exposed separately. One respondent (CL11) made an analogy between assets held for rental and a cab business. Although the cars are used for transportation instead of being rented, they are routinely sold when they ceased to be used.

8. The staff are of the view that the proposed amendment reflects the principle set out in paragraph 72 of the *Framework* that it is helpful to distinguish between income and expenses that arise from ordinary activities and those that do not. The Board considered assets in the scope of IAS 16 and noted that there was a clear distinction between assets held for rental and assets held for use. In the case of assets rented out to others and then routinely sold, the Board noted that

[1] (eg CL6, CL11, CL14, CL17, CL32, CL 41 and CL53)

the ordinary activity of the entity was both renting and selling such assets. Therefore, revenue from the rents and the proceeds from the sales should both be recognised as revenue. In the case of assets held for use by the entity, the Board noted that almost all entities eventually sell PPE and it happens quite often. The Board confirmed its view that revenue from the sale of these assets should be reported on a net basis. On that basis, the staff do not see any objective way to distinguish between the cab example and other PPE held for use.

B) Address the inconsistency with IAS 40

9. Some respondents (CL14, CL 50) believed that the proposed amendment is not consistent with paragraph 58 of IAS 40 that specifically prohibits an entity from transferring investment property to inventory simply when it has decided to sell the asset. They also pointed to paragraph 57(b) of IAS 40 that allows such transfer only when there is a change in use, evidenced by commencement of development with a view to sale.

10. The staff's view is that the proposal is totally consistent with IAS 40 and with its requirement for change in use. The proposal requires that an entity should not transfer the item to inventory until it stops renting it. The staff note that this transfer does not depend on management decision or intention.

C) Clarify the interaction with IFRS 5

11. One respondent (CL 11) asked the Board to clarify whether IFRS 5 applies to the assets considered in the proposed amendment. Another (CL59) also thought it would be appropriate to add disclosures to explain the reason why the sale of these assets should not be accounted for in accordance with IFRS 5. Two others (CL44 and CL54) asked for clarification of the term 'held for sale' in the proposed amendment claiming that such wording could be confusing with the notion of held for sale in IFRS 5. One of them proposed the term 'held for sale <u>in the ordinary course of business</u>' (emphasis added).

12. The staff note that the Board already considered these issues. The proposed amendment to IAS 16 clearly states that the assets should be transferred to inventories which are held for sale in the ordinary course of business and are generally not non-current assets, implying that IFRS 5 does not apply. However, the staff propose amending the basis for conclusions to clarify that IFRS 5 should not be applied in such circumstances. The staff also note that the term 'held for

sale' is not only used in IFRS 5 but also in IAS 2 in the definition of inventories. The staff do not believe there is confusion around this term.

D) Disclosures

13. One respondent (CL54) proposed including a requirement that this category of assets be classified as a separate class under PPE. This respondent considered it important for users of financial statements to distinguish investments in such assets from the other PPE. One respondent (CL59) also thought it would be appropriate to add disclosures to explain that the change in use must be clearly evidenced (as required by IAS 40 paragraph 57b) and the reason why the sale of these assets should not be accounted for in accordance with IFRS 5.

14. The staff note that the Board concluded in BC5 of the proposed amendment that the disclosure requirements of IAS 16, IAS 2 and IAS 18 would lead an entity to disclose relevant information about these assets for users. This is because IAS 16 and IAS 2 require separate disclosure of material types of PPE and inventory and IAS 18 requires separate disclosure for material sources of revenue. Therefore, the staff disagree with the proposal that further disclosures are needed.

E) Consequential amendment of IAS 7 *Statement of Cash Flows*

15. The consequential amendment of IAS 7 results from the proposed amendment of IAS 16 on sales of assets held for rental and requires presenting within operating activities cash payments to manufacture or acquire such assets and cash receipts from rents and sales of such assets.

16. Some respondents (eg CL19, CL44, CL48, CL50) did not agree with that consequential amendment. They were of the view that the cash payments should be classified as investing activities as they relate to PPE that are long-term assets. One respondent (CL50) believed that it is impracticable to require an entity to assess, on initial purchase of an asset, what its future intentions are and recommend that the amendment addresses only the presentation in the income statement.

17. The staff believe that, when the asset is acquired, if there is any question whether it will be routinely sold, this amendment is not applicable. If the acquisition of the asset is treated as an investing activity and the sale is treated as operating, cash flows from operations will be misstated. Therefore, presenting both the

cash payments and cash receipts within operating activities seems to be the appropriate answer.

Staff recommendation

18. The staff note that most respondents agreed with the proposal or did not comment. Some respondents expressed concern about the scope of the project and the approach taken by the Board to clarify a narrow issue. However, the staff believe that this amendment will be useful for constituents because there is diversity in practice in industries in which assets are rented and then routinely sold.

19. The staff propose amending the basis for conclusions to clarify that IFRS 5 should not be applied in such circumstances. The staff will include those drafting changes in the pre-ballot draft.

20. Question to the Board: does the Board agree with staff analysis and recommendation?