Project **Tentative Agenda Decision**

Topic **IFRS 1 *First-time Adoption of International Financial Reporting Standards* – Accounting for costs included in self-constructed assets on transition**

Purpose of this paper

1. The purpose of this paper is to address requests made by the IFRIC at their January 2010 meeting for the staff to perform additional research relating to the accounting for costs included in self-constructed assets on transition to IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

2. Specifically, the IFRIC requested that the staff perform further:

   (a) outreach relating to diversity in practice for the accounting of costs included in self-constructed assets when an entity changes accounting policies relating to these costs (eg actuarial gains and losses) on transition to IFRS.

   (b) research to determine if existing IFRS preparers adjust the carrying amount of self-constructed assets following a change in accounting policies in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* that relates to costs included within these assets. An example would be a change from a 'corridor' approach to instead recognising all actuarial gains and losses in other comprehensive income (OCI).

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IFRIC.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRIC or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

(c) analysis of the definition of costs capitalised within self-constructed assets. This includes consideration of how these costs relate to amounts that would otherwise be recognised in OCI or in profit or loss.

Background information

3. In October and December 2009, the IFRIC received requests identifying an entity that capitalised costs as part of self-constructed assets in accordance with its previous GAAP accounting policy. This previous GAAP accounting policy is also compliant with IFRSs (eg IAS 2 *Inventories* or IAS 11 *Construction Contracts*).

4. On transition to IFRSs, the entity elects to change the accounting policy relating to some of these costs that are included within self-constructed assets, specifically relating to whether certain actuarial gains and losses are recognised in profit or loss, or within OCI.

5. As a result of this change in accounting policy, the entity changes the amount of costs it will capitalise within self-constructed assets.

6. The entity requested guidance on how this change should be reflected in its financial statements at, and subsequent to, application of IFRS 1.

7. The staff analysis of the specific issues included in these two requests was presented as Agenda Paper 15 at the January 2010 IFRIC meeting.[1]

8. Following discussion in the January 2010 IFRIC meeting, the IFRIC asked the staff to perform additional analysis on situations broader than the examples presented in the requests.

9. Specifically, the IFRIC requested the staff to obtain additional feedback on the extent of diversity in practice in reflecting a change in accounting policy relating

[1] AP 15 January 2010 IFRIC - Costs Included In Self Constructed Assets at Transition

to costs included within self-constructed assets, and to consider the nature of costs that may be capitalised within self-constructed assets.

Staff analysis

Extent of diversity in practice on transition to IFRS

10. Both before, and after, the January 2010 IFRIC meeting, the staff performed outreach to determine the extent of diversity in practice relating to the accounting for costs included in self-constructed assets when an entity changes accounting policies on adoption of IFRS.

11. This outreach indicates that the issues raised in the requests were not common within reporting entities that have already transitioned to IFRS. However they may have practical relevance in jurisdictions expecting to adopt IFRSs for the first time.

12. The staff believe that this feedback indicates a lack of significant diversity in practice relating to these issues. This reflects the view of the staff that the issues are limited in their relevance to reporting entities that:

    (i) change their accounting policy for costs on adoption of IFRSs;

    (ii) capitalise a material amount of costs within self-constructed assets (specifically as part of construction contracts or within inventory); and

    (iii) include within the cost of self-constructed assets a material amount of costs that are subject to the change in accounting policy at the date of transition to IFRSs.

Extent of diversity in practice after transition to IFRS

13. After transition to IFRS, an entity may, in accordance with IAS 8, change accounting policies relating to the recognition of certain costs, a portion of which it capitalises within self-constructed assets. However, the entity may not change its accounting policies relating to the capitalisation of costs within self-constructed assets (eg in accordance with IAS 2 or IAS 11).
14. The staff performed outreach to understand whether, in practice, reporting entities change their basis for capitalising costs within self-constructed assets following a change in accounting policy that changes the amount of these costs that would otherwise be recognised in profit or loss or OCI.
15. The outreach indicates that there is limited practical experience of entities changing their capitalisation methodology following a change in accounting policies relating to costs capitalised within self-constructed assets.
16. The rationale for this was consistent with that expressed in paragraph 12 above.
17. This also reflects the methodology used by many preparers to identify and record costs to be capitalised. Typically, preparers use standard costing to capitalise costs within self-constructed assets, rather than using an approach that relates directly to the amount of costs recorded in profit or loss or in OCI in the current reporting period. As a result, preparers may reflect the change in costs on a prospective basis as an adjustment arising from their standard cost variance analysis.

Nature of costs that may be capitalised within self-constructed assets

18. In the January 2010 IFRIC meeting, the IFRIC discussed the specific issue raised in the requests (which related to actuarial gains and losses) and whether the requests highlight broader issues.

19. These broader issues relate to the nature of costs that are appropriate for capitalisation within self-constructed assets, and the relationship between these capitalised costs and how they would otherwise be recognised in OCI or in profit or loss.

Definition of costs

20. IFRSs define cost as follows:

> The amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2. (IAS 16.6, IAS 38.8 and IAS 40.5)

21. Further guidance on the nature of costs that may be capitalised within self-constructed assets is provided in IFRSs, including those listed below:

    (a) The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. (IAS 2.10)

    (b) Contract costs shall comprise:

    > (a) costs that relate directly to the specific contract;
    >
    > (b) costs that are attributable to contract activity in general and can be allocated to the contract; and
    >
    > (c) such other costs as are specifically chargeable to the customer under the terms of the contract. (IAS 11.16)

    (c) The cost of an item of property, plant and equipment comprises:

    > (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

> (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
>
> (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.
> (IAS 16.16, with further guidance included in IAS 16.17)

22. This IFRS guidance on the definition of cost does not refer to how these amounts should be presented in the financial statements if they were not included within the carrying amount of a self-constructed asset.

23. For example, this guidance does not state that these costs should represent only expenses that the entity would otherwise recognise in profit or loss for the current reporting period. Instead, the IFRS glossary and IFRSs relating to self-constructed assets provide guidance on expenses separately from cost.

Costs that would otherwise be recognised in OCI

24. The cost definition within IFRSs raises the question of whether costs can be capitalised if they would otherwise be recognised in OCI rather than in profit or loss.

25. The staff consider that this may be possible, because IFRSs do not include any principle that prohibits capitalisation of items that would otherwise be recognised in OCI. Additionally, there is no guidance in IFRS that prevents capitalisation of items that are recycled from OCI to profit or loss in a reporting period.

26. Determination of whether items (eg relating to cash flow or net investment hedges, currency translation differences or available-for-sale investments) that would otherwise be recognised in OCI meet the criteria for capitalisation depends on the nature of the specific items.

27. Consider as an example basis adjustments for hedges of forecast transactions that will result in the recognition of a non-financial asset.

28. Paragraph 98 of IAS 39 Financial Instruments: *Recognition and Measurement* provides entities with an accounting choice that may result in basis adjustments that would otherwise be recognised in OCI being recognised in the cost of an asset.

29. The Board's Basis for Conclusions in IAS 39.BC163 allows this treatment:

> because such changes represent a part of the 'cost' of that asset or liability

30. If an entity concludes that certain costs that would otherwise be recognised in OCI can be capitalised, it would need to determine how to recognise the subsequent accounting in the financial statements. This includes the question of whether some of the amortisation/depreciation, impairment and derecognition of the capitalised costs should be recognised in OCI rather than profit or loss.

31. Some may consider that recognition through profit or loss on a basis consistent with other costs capitalised within the asset is appropriate, because this reflects the 'new identity' of these costs.

32. Others believe recognition in profit or loss should be consistent with how these costs would have been recycled from OCI to profit and loss if they had not been capitalised within self-constructed assets.

33. Proponents of this second view have significant concerns about the accounting for a situation where IFRSs prohibits the cost from being recycled from OCI into profit or loss if it was not capitalised.

34. They believe that, in this situation, the subsequent accounting for these costs, such as recognition of amortisation/depreciation, must be recognised in OCI, rather than in profit or loss.

35. Consequently, the staff believe, although IFRSs do not explicitly preclude capitalisation within self-constructed assets of costs that would otherwise be recognised in OCI, that:

    (a) a very specific and narrow fact pattern would be needed for such a cost to meet the criteria in IFRSs for capitalisation; and

(b) practical implementation challenges may exist in determining the appropriate subsequent accounting to be applied to these costs after capitalisation.

Costs that would otherwise be recognised in profit or loss

36. Some raise a further question of whether costs must be capitalised within self-constructed assets on a basis consistent with how they would otherwise be recognised in profit or loss.

37. They argue that situations exist where the timing and pattern of costs capitalised within self-constructed assets should be different from the amounts that would otherwise be recognised in profit or loss.

38. For example, an entity may change an accounting policy, or an accounting estimate, relating to how it recognises a cost in profit or loss (a portion of which is then capitalised within self-constructed assets).

39. The issue then arises as to whether the entity is required to change the portion of these costs that are capitalised to reflect this change in accounting policy, or estimate.

40. Some believe that in certain circumstances the method of capitalising these costs within self-constructed assets should remain unchanged, such as when the change in accounting policy, or estimate, does not reflect any change in the fair value of costs being incurred to construct the asset.

41. Current IFRSs could also lead to similar costs being recognised in profit and loss differently.

42. An example would be the differences in IFRS 2 *Share-based Payment* for recognising cash-settled, and equity-settled, share-based payment transactions.

43. When an entity capitalises direct labour costs within self-constructed assets, the question may arise as to the appropriate amount of share-based payment costs to be capitalised. Should the amounts capitalised within self-constructed assets be consistent with the amount that would otherwise be reflected in profit or loss, or should it reflect a fair value amount each reporting period?

44. The staff believe that a capitalisation methodology should be applied on a consistent basis.

45. To the extent this methodology estimates costs on the basis of amounts that would otherwise be recognised in profit or loss, a change in the accounting policy, or estimate, of a cost, a portion of which is capitalised within self-constructed assets, should be reflected in the carrying amount of the self-constructed asset in accordance with IAS 8.

Actuarial gains and losses example in the requests

46. In relation to the actuarial gains and losses example included in the requests, many of the outreach responses questioned whether actuarial gains and losses, regardless of whether they would otherwise be recorded in profit or loss or in OCI, meet the capitalisation criteria in IFRS.

47. Some interpret the guidance in IAS 19 as preventing capitalisation of actuarial gains and losses that would otherwise be recognised in OCI. They believe that IAS 19 requires all such gains and losses to be recognised in OCI:

> If, as permitted by paragraph 93, an entity adopts a policy of recognising actuarial gains and losses in the period in which they occur, it may *recognise them in other comprehensive income*, in accordance with paragraphs 93B–93D, *providing it does so for:*
>
> (a) all of its defined benefit plans; and
>
> (b) *all of its actuarial gains and losses.* (IAS 19.93A) (emphasis added)

48. They also argue that the guidance in IAS 19 relating to capitalisation of employee benefit costs only refers to costs that would otherwise be recognised in profit or loss:

> Other Standards require the inclusion of certain employee benefit costs within the cost of assets such as inventories or property, plant and equipment (see IAS 2 and IAS 16). Any post-employment benefit costs included in the cost of such assets include the appropriate proportion of the components listed in paragraph 61 [which only includes those items recognised in profit or loss]. (IAS 19.62)

49. Others argue that the criteria in paragraph 21 above for capitalisation may not be met, regardless of whether these actuarial gains and losses would otherwise be recognised in profit or loss or in OCI.

50. They believe that employee benefit costs should be disaggregated for the purpose of determining which costs components can be capitalised.

51. Capitalisation of components relating to current service cost, interest cost, or, in some instances, past service costs may be appropriate. However, other components of employee benefit costs, including actuarial gains and losses, may not meet the capitalisation criteria because they:

    (a) do not meet the definition of 'cost'. Instead they reflect gains and losses relating to remeasurement, rather than amounts paid or the fair value of consideration given.

    (b) are volatile in nature, creating both debits **and** credits that relate to changes in assumptions and estimates that are not closely related to the construction of an asset.

    (c) do not qualify as costs that are directly attributable to the self-constructed asset.

Staff recommendation

52. The staff believe that the outreach feedback indicates limited evidence for the issues in the requests arising in practice within current IFRS preparers.

53. In broadening the issue to consider the nature of costs that may be capitalised within self-constructed assets, the staff believe that the focus should be on costs that meet the entity's capitalisation policy in accordance with IFRSs, including IAS 2, IAS 11 and IAS 16.

54. However, these costs may not necessarily be limited to items that are otherwise recorded in profit or loss in the current reporting period, and may include costs that would otherwise be recognised in OCI.

55. In relation to the specific issues in the agenda requests, the staff views remain consistent with those expressed in the January 2010 staff agenda paper.

56. If, on transition, an entity determines that a component of costs capitalised under previous GAAP, such as actuarial gains and losses, do not meet the capitalisation criteria in IFRSs, then those costs should be excluded from the carrying amount of self-constructed assets in the IFRS financial statements for all periods presented in accordance with IFRS 1.

57. This view is consistent with the following guidance:

> An entity shall use the same accounting policies in its opening IFRS statement of financial position and throughout all periods presented in its first IFRS financial statements. Those accounting policies shall comply with each IFRS effective at the end of its first IFRS reporting period (IFRS 1.7)
>
> an entity could use the fair value of an item of property, plant and equipment at the date of transition to IFRSs as its deemed cost at that date if determining a *cost-based measurement in accordance with IFRSs* would involve undue cost or effort. (emphasis added) (IFRS 1.BC 41)

Agenda criteria assessment for the IFRIC

58. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *The issue is widespread and has practical relevance.*

    No.

    The staff are not aware of the issues being raised by existing users of IFRSs, either arising from adoption of IFRS 1, or as a result of a subsequent change in the actuarial gains and losses accounting policy in accordance with IAS 8.

    The staff understand that the issues do have practical relevance in jurisdictions expecting to adopt IFRSs for the first time.

    However, the staff believe that the issues are limited in their relevance to reporting entities that:

(i) change their accounting policy for actuarial gains and losses on adoption of IFRSs;

(ii) capitalise a material amount of costs within self-constructed assets (specifically as part of construction contracts or within inventory); and

(iii) include within the cost of self-constructed assets a material amount of actuarial gains and losses at the date of transition to IFRSs (eg as a result of a significant pension deficit).

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The IFRIC will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

No. The staff believe that in relation to the specific issues in the requests that current IFRSs are clear, and that IFRS 1.7 requires:

> the same accounting policies in its opening IFRS statement of financial position and throughout all periods presented in its first IFRS financial statements. Those accounting policies shall comply with each IFRS effective at the end of its first IFRS reporting period.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

Yes. Financial reporting would be improved through the elimination of diversity in recognising and measuring actuarial gains and losses that are capitalised within self-constructed assets.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

Yes. The staff believe that these issues are narrow enough that they could be resolved efficiently within the confines of existing IFRSs and the Framework.

(e) *It is probable that the IFRIC will be able to reach a consensus on the issue on a timely basis.*

Yes. It is probable that the IFRIC would be able to reach a consensus on these issues on a timely basis.

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC requires to complete its due process.*

Not applicable. The IASB does not have any current or planned projects on its agenda that are expected to address these issues.

59. Based on the assessment of the agenda criteria, the staff recommend that the IFRIC should not add the issue to its agenda.

60. The proposed wording for the tentative agenda decision is set out in Appendix A.

Question for the IFRIC
1. Does the IFRIC agree with the staff's recommendation not to add this issue to its agenda? If not, how does the IFRIC recommend the staff to proceed? 2. Does the IFRIC have any comments on the proposed wording for the tentative agenda decision in Appendix A?

Appendix A – Proposed wording for agenda decision

IFRS 1 *First-time Adoption of International Financial Reporting Standards* – Accounting for costs included in self-constructed assets on transition

The IFRIC received two requests identifying an entity that capitalises certain costs as part of self-constructed assets. The entity determines that certain cost components capitalised under previous GAAP cannot be capitalised in accordance with the entity's IFRS accounting policies. As a result, the requests ask how the entity should measure self-constructed assets on transition to IFRS.

The IFRIC noted that paragraph 7 of IFRS 1 requires an entity to use 'the same accounting policies in its opening IFRS statement of financial position and throughout all periods presented in its first IFRS financial statements. Those accounting policies shall comply with each IFRS effective at the end of its first IFRS reporting period', except for certain exemptions that do not apply to self-constructed assets recognised in accordance with IAS 2 *Inventories* or IAS 11 *Construction Contracts*.

The IFRIC concluded that the issue is not widespread and that there are not significantly divergent interpretations (either emerging or already existing in practice). The IFRIC therefore [decided] not to add this issue to its agenda.