Project **Tentative agenda decision**

Topic **IAS 16 *Property, Plant and Equipment*—cost of testing**

Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a request to clarify the accounting for sales proceeds received from testing an asset before it is ready for its intended use.

Purpose of the paper

2. The objective of this paper is to:
   (a) outline the issue;
   (b) provide an analysis of the issue;
   (c) assess the issue against the Interpretations Committee's criteria;
   (d) make a recommendation that the Interpretations Committee should not take the issue onto its agenda; and
   (e) ask whether the Interpretations Committee agrees with the staff's recommendation.

The issue

3. The formal submission is provided in full in appendix A. Additionally we have received more details from the submitter about the case considered in the submission. This additional information has been incorporated into the summary presented below.

4. The context of the submission is a petrochemical complex with several plants, some of which are ready for use by management and producing chemicals that are sold on the market, while others are still in the commissioning phase and not yet ready for production. Those plants that are ready for use have been issued an inspection certificate by an authorised body to attest they are ready for commercial production.

5. In addition, the chemical products sold on the market are only produced by those plants that are certified as ready for commercial production.

6. The regulator from the jurisdiction in which the petrochemical complex operates has set out specific financial reporting requirements. These financial reporting requirements differ based on whether or not the complex has reached its "commercial production date". Determination of when the commercial production date is reached is made by the entity. In the example described in the submission, the company wishes that this date be the date when all plants within the complex are ready for use.

7. The question arising from this specific case is whether, with respect to paragraph 17(e) of IAS 16, revenue from products produced from completed plants and sold on the market could be used to offset the costs of testing the other plants that are still in the commissioning phase. That is, could such revenues be accounted for as a reduction in the cost of plants being constructed, rather than recognised as revenue in profit or loss?

Staff's analysis

8. For ease of reference, paragraph 17 of IAS 16 is reproduced below:

> 17 Examples of directly attributable costs are:
>
> (a) costs of employee benefits (as defined in IAS 19 *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;
>
> (b) costs of site preparation;
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> (c) initial delivery and handling costs;
>
> (d) installation and assembly costs;
>
> (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
>
> (f) professional fees.

9. Our understanding of paragraph 17(e) of IAS 16 is that it refers to costs of testing incurred before a particular item of property, plant and equipment (PPE) is brought to the location and to the condition necessary for it to be capable of operating in the manner intended by management. In addition, we think that this paragraph was primarily designed to address situations in which revenue from products sold under the testing phase would be significantly lower than the costs of testing.

10. We read paragraph 17(e) of IAS 16 as applying separately to each individual plant. Chemicals sold on the market are produced once the asset is operating in the manner intended by management. In our opinion, revenue from those products should not give rise to 'net proceeds' to be offset against the costs of testing other plants that are part of the complex; the revenue should instead be recognised in profit or loss for the period, because it reflects the operations of the entity for the period.

11. More specifically, we note that the 'commercial production date' for the whole complex arises from regulation. It does not tie back to the criterion in paragraph 16(b) of IAS 16 that sets the requirements for costs that are elements of the cost of the item of PPE based on whether the item is ready for its intended use.

Consequently, for accounting purposes, we would not consider this date as the start date for the production from the complex as a whole.

12. We therefore do not support the argument that, before the so-called 'commercial production date' for the site as a whole, production from the plants that are already in operation is non-commercial production. Consequently, we believe that proceeds from those sales are distinct from the costs of testing other plants that are not yet ready for their intended use. Sales proceeds from plants that are producing should be accounted for in accordance with IAS 18 *Revenue*.

13. In addition, we think that this analysis is consistent with the example in paragraph 21of IAS 16 that illustrates what are elements of cost versus revenue and expenses:

> 21 For example, income may be earned through using a building site as a car park until construction starts. Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in profit or loss and included in their respective classifications of income and expense.

Assessment against the Interpretations Committee's criteria

14. The staff's assessment of the Interpretations Committee's agenda criteria is as follows:

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

No. We are only aware of this issue arising in one jurisdiction and in a specific industry.

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

There are currently differing views within the jurisdiction. However, we believe that existing IFRS guidance on this matter is sufficient and we do not expect divergent interpretation in practice.

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

We think that existing IFRSs should not be amended.

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

We think that the current guidance is sufficient to address the issue.

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

We believe that the Committee should reach a consensus that there is no need for an interpretation on this issue.

(f) *If the issue relates to current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (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 would require to complete its due process).*

The issue does not relate to a current Board project.

15. We believe that the issue does not meet the criteria for the Interpretations Committee to take it onto its agenda.

Staff's recommendation

16. We recommend that the Interpretations Committee should not take the issue onto its agenda.

17. We propose a draft wording for a tentative agenda decision in Appendix B to this paper.

Question to the Interpretations Committee

Question—staff's recommendation
Does the Interpretations Committee agree with the staff's recommendation?

Appendix A—Submission

The issue:

A petrochemical company is setting up an integrated petrochemical complex. Besides a number of processing plants, the complex include common utilities (e.g boiler plant, cooling tower, compressed air and main power receiving station). The complex comprises of a number of plants which produce specific petrochemical products. Certain products are meant for captive use while some excess over captive used are sold to the market. Other products are entirely directed to the market. The company is in the trial run or testing stage.

Current practice:

According to IAS 16 (e) "costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment);" is considered as directly attributable costs of the asset tested.

The above company derived substantial revenue from such sales which was deducted from the total capital cost, in accordance with paragraph 17(e) of IAS 16.

Reasons for the IFRIC to address the issue:

The questions are:

1. How to treat any excess net proceeds over the cost of testing of an asset, i.e. after extinguishing all the cost of testing, e.g. proceeds $5M,cost of testing $3M?

2. How to treat any excess net proceeds over the cost of trial run of the complex as a whole, i.e. after extinguishing all the cost of the trial run, in such a case where there are multiple plants most of them are functioning properly alone?

The above questions are based on the following concerns which lead to inconsistent accounting treatment of directly attributable costs of PPE in the petrochemical sector:

- Normally the period of trial run is not very long. Where the period of trial run gets prolonged due to abnormal reasons, abnormal period should not be considered as a part of the trial run period for capitalisation of expenditure.
- If a petrochemical plant is able to produce the desired goods in one particular plant, then in such situation, revenue from such sales in the testing phase, should not be allowed to be deducted from the capital cost and be treated as a revenue item.

Appendix B – Draft wording for a tentative agenda decision

IAS 16 *Property, Plant and Equipment*—cost of testing

The Interpretations Committee received a request to clarify the accounting for sales proceeds from testing an asset before it is ready for its intended use. The fact pattern in the submission is of an industrial group with several plants being ready for their intended use at different points in time. This group is subject to a regulation that requires the group to identify a 'commercial production date' for the whole industrial complex. The question asked of the Committee is whether the proceeds from those plants already in operation can be offset against the costs of testing those plants that are not yet ready for their intended use.

The Committee observed that the 'commercial production date' referred to in the submission for the whole complex was a different concept from the 'ready for intended use' assessment in paragraph 16(b) of IAS 16. The Committee believes that the guidance in IAS 16 is sufficient to identify the date at which an item of property, plant and equipment is 'ready for intended use' and therefore to distinguish proceeds that offset costs of testing the asset from revenue from commercial production.

The Committee thinks that further guidance would be in the nature of implementation guidance rather than interpretive guidance. The Committee therefore [decided] that this issue should not be added to its agenda.