

STAFF PAPER

17 January – 18 January 2012

IFRS Interpretations Committee Meeting

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Project	2009-2011 Annual improvements cycle (ED June 2011)— Comment letter analysis		
Paper topic	IAS 16 <i>Property, Plant and Equipment</i> —Classification of servicing equipment		
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Introduction

1. The exposure draft of proposed *Improvements to IFRSs* published in June 2011 includes a proposal for an amendment to paragraph 8 of IAS 16 *Property, Plant and Equipment* that would clarify that servicing equipment should be classified as property, plant and equipment (PPE) when it is used during more than one period and as inventory otherwise.

Objective of this paper

2. The objective of this paper is to provide an analysis of the comment letters received on the proposal to amend paragraph 8 of IAS 16 and to obtain a final decision from the IFRS Interpretation Committee (the ‘Committee’) to allow this issue to be included in the final *Improvements to IFRSs* planned to be issued in 2012.

Structure of this paper

3. This agenda paper:
 - (a) provides background information on the issue;
 - (b) analyses the comments received as part of the exposure draft process and recommends any changes to the proposed draft wording; and
 - (c) asks the Committee to confirm whether they agree with the staff recommendation to proceed with the proposed amendment by adding some further changes that would make the proposed amendment clearer.

Background

Current guidance in IAS 16 regarding the classification of servicing equipment

4. Paragraph 8 of IAS 16 provides guidance for the classification of servicing equipment; it states that:
 - 8 Spare parts and servicing equipment are usually carried as inventory and recognised in profit or loss as consumed. However, major spare parts and stand-by equipment qualify as property, plant and equipment when an entity expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property, plant and equipment, they are accounted for as property, plant and equipment.
5. The first sentence of the above paragraph provides guidance to classify spare parts and servicing equipment as inventory. The second sentence provides guidance for major spare parts and stand-by equipment to be classified as PPE when it is expected that they will be used during more than one period.

6. The term ‘servicing equipment’ is mentioned in the first sentence, but it is not referred to in the second sentence. In addition, the last sentence requires servicing equipment to be classified as PPE when it is used only in connection with an item of PPE.

Issues raised that led to the proposed amendment

7. Constituents observed that paragraph 8 of IAS 16 is unclear regarding the classification of servicing equipment as PPE or as inventory. The confusion arises from a perceived contradiction in the way in which servicing equipment is addressed in the paragraph (ie servicing equipment is mentioned in the first sentence, but it is not mentioned in the second sentence).
8. This contradiction leads to classifying servicing equipment as inventory when it is:
 - (a) used during more than one period; and
 - (b) not used only in connection with an item of PPE.
9. Consequently, the Board was asked to clarify that servicing equipment used during more than one period is an item of PPE.

The Board’s proposal to address the issues raised

10. To address these concerns in May 2010¹, the Committee recommended to the Board that it should amend IAS 16 in order to:
 - (a) clarify that servicing equipment is PPE when an entity expects to use it in more than one period but that it is inventory when the entity expects to use it in less than one complete period; and
 - (b) to delete the requirement that spare parts and servicing equipment used during only one period in connection with an item of PPE must be classified as PPE.

¹ <http://www.ifrs.org/NR/rdonlyres/19B6C905-68C0-4D44-9DF1-4CE9D825B1F9/0/1005ap16obsAIPIAS16andservicingequipment.pdf>

11. At the Board meeting in July 2010², the Board agreed with the Committee's proposal and decided to include the proposed amendment within the 2009–2011 *Annual Improvements* cycle.
12. The proposed amendment to paragraph 8 of IAS 16 is reproduced below for ease of reference:
 - 8 Spare parts and servicing equipment are usually carried as inventory and recognised in profit or loss as consumed. However, major spare parts, ~~and~~ stand-by equipment and servicing equipment qualify as property, plant and equipment when an entity expects to use them during more than one period. ~~Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property, plant and equipment, they are accounted for as property, plant and equipment.~~
13. In this paper, we discuss and analyse the comments received from constituents during the comment period which ended on 21 October 2011.

Comment letter analysis

14. The Board received 67 comment letters on the exposure draft (ED). The ED asked two questions:
 - (a) Question 1: Do you agree with the Board's proposal to amend the IFRS as described in the exposure draft? If not, why and what alternative do you propose? [57 respondents answered this question]
 - (b) Question 2: Do you agree with the proposed transitional provisions and effective date for the issue as described in the exposure draft? [49 respondents answered this question]

² <http://www.ifrs.org/Meetings/IASB+Board+Meeting+21+July+2010.htm> Agenda Paper 14B

Main concerns identified

15. A majority of respondents broadly agree with the proposal to clarify that servicing equipment should be classified as PPE when it is used during more than one period and as inventory otherwise. However many raised comments on the proposals as explained in the following paragraphs.
16. Some of those who partially agree believe that further clarification will be necessary in paragraph 8 of IAS 16. In particular:
 - (a) many respondents³ think that the proposed wording should be simplified (**‘Issue 1’**), because it is not clear what the difference is between ‘spare parts’ and ‘major spare parts’ and the difference between ‘servicing equipment’ and ‘stand-by equipment’ (ie the term ‘servicing equipment’ should be defined). In other words, they think that the proposed wording seems to be inconsistent, because the first sentence of the proposed paragraph 8 refers to ‘spare parts’ and ‘servicing equipment’ while the second sentence refers to ‘major spare parts’, ‘stand-by equipment’ and ‘servicing equipment’;
 - (b) some respondents (CL 19 SAICA, CL 25 FAR, CL 38 Japanese Institute of CPA and CL 59 Hong Kong Institute of CPA) think that the term ‘period’ should be defined (**‘Issue 2’**);
 - (c) some respondents (CL 17 Roche, CL 20 Nestle, CL 62 Swiss Holdings and CL 66 Volkswagen) who disagree with the proposed amendment, believe that the amendment will result in administrative costs and practical issues (eg it would be difficult to determine the useful life of spare parts; depreciation would need to be charged if they are classified as PPE, but not if they are classified as inventory) (**‘Issue 3’**);

³ See comment letters (CL) 1 (Linus Low), CL 12 (BP), CL 18 (BT), CL 27 (KASB), CL 34 (ASC), CL37 (RSM), CL59 (Hong Kong Institute of CPA) and CL 63 (Shell).

- (d) some respondents (CL 5 DT, CL 18 BT, CL 37 RSM, CL 40 Moore Stephens and CL 66 Volkswagen) disagree with the full retrospective application of the proposed amendment (**‘Issue 4’**).

17. The comments and concerns raised by respondents are analysed in subsequent paragraphs.

Issue 1: the proposed wording should be simplified

18. Respondents think that the proposed wording should be simplified, because:

- (a) some of them (CL1 Linus Low, CL59 Hong Kong Institute of CPA and CL 63 Shell) do not understand the difference between ‘spare parts’ and ‘major spare parts’. They do not see the need to make such a distinction (for example, people could take it to mean that spare parts that are less expensive would not qualify as PPE and we do not think that this is the Board’s intention), so they suggest deleting the word ‘major’ from paragraph 8;
- (b) some others (CL 1Linus Low, CL 12 BP, CL 18 BT) do not understand the difference between ‘servicing equipment’ and ‘stand-by equipment’; consequently, they think that these terms should be defined, because otherwise the amendment may lead to inconsistent interpretation or application; and
- (c) some respondents (CL 27 KASB and CL 34 ASC) think that the proposed wording seems to be inconsistent, because the first sentence of the proposed paragraph 8 refers to ‘spare parts’ and ‘servicing equipment’; while the second sentence refers to ‘major spare parts’, ‘stand-by equipment’ and ‘servicing equipment’. They claim that the reference to ‘stand-by equipment’ should therefore be included in the first sentence.

Staff analysis and recommendation on Issue 1

19. We think that to avoid confusion the proposed wording of paragraph 8 of IAS 16 should be simplified by:

- (a) not making explicit reference to particular types of equipment.
 - (b) referring to the definition of “property, plant and equipment” in paragraph 6 of IAS 16 and to the definition of “inventories” in paragraph 6 of IAS 2 *Inventories* as they already provide sufficient guidance on the classification of tangible items (including spare parts).
20. The definition of ‘Property, plant and equipment’ in paragraph 6 of IAS 16 and the definition of ‘Inventories’ in paragraph 6 of IAS 2 are reproduced below for ease of reference (emphasis added):
- 6 Property, plant and equipment are tangible items that:**
- (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
 - (b) **are expected to be used during more than one period.**
- 6 *Inventories* are assets:**
- (a) held for sale in the ordinary course of business;
 - (b) in the process of production for such sale; or
 - (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.
21. Consequently, we think that the Committee should recommend to the Board that it should clarify that items such as spare parts, stand-by equipment and servicing equipment qualify as property, plant and equipment when they meet the definition of property, plant and equipment, otherwise, they are classified as inventory.
22. Our recommended changes to the draft wording of the proposed amendment are included in Appendix A and B of this paper.

Issue 2: the term ‘period’ should be defined

23. Some respondents (CL 19, CL 25, CL 38 and CL 59) think that the term ‘period’ should be defined, because this term is not defined in IFRSs and it is not clear whether the term ‘period’ means:
- (a) annual reporting period;
 - (b) interim reporting period; or
 - (c) a 12-month period from the date of acquisition, regardless of the reporting period.
24. Consequently, in order to ensure consistency in practice, they ask the Committee to define the term ‘period’ or to clarify that ‘major spare parts, stand-by equipment and servicing equipment qualify as property, plant and equipment when an entity expects to use them during more than one annual period’.

Staff analysis and recommendation on Issue 2

25. We think that a clarification of the definition of the term ‘period’ is outside the scope of the proposed amendment.
26. We also note that the definition of PPE uses the term ‘period’ and that IAS 16 never uses the term ‘annual period’, while other standards (ie IFRS 1, IFRS 3, IFRS 8, IAS 1, IAS 19, IAS 34, IAS 36, IAS 38 and IAS 39) sometimes use the term ‘annual period’.
27. For Issue 1, we have proposed a simplification of the wording in paragraph 8 of IAS 16 that omits the word ‘period’ (ie ‘items such as spare parts, stand-by equipment and servicing equipment qualify as PPE when they meet the definition of PPE, otherwise they are classified as inventory’). Consequently, we think that a further amendment to define the term ‘period’ is not necessary and so we do not think that the Committee should address this issue.

Issue 3: the amendment will result in administrative costs

28. Some respondents do not support the proposed amendment, because they believe that:
- (a) the proposal does not add any additional beneficial information to users (CL 17 Roche);
 - (b) the proposal will distort management’s ability to monitor actual movements in spare parts used for servicing equipment (CL 17 Roche);
 - (c) the implementation of the proposal will be time-consuming and expensive (CL 17 Roche and CL 66 Volkswagen);
 - (d) it is not clear for how long their spare parts are going to be held for when they acquire them, and therefore they would have to often reclassify spare parts from inventories to PPE or vice versa (CL 20 Nestlé); and
 - (e) determining the useful life of spare parts would not be easy (CL 20 Nestlé and CL 62 Swiss Holdings).
29. Consequently, these respondents suggest withdrawing the proposed amendment.

Staff analysis and recommendation on Issue 3

30. We reaffirm our view that to avoid confusion, the proposed amendment should be simplified in the way that we proposed on Issue 1, because we think that the Board’s intention was to clarify (not to modify) the classification of servicing equipment.

Issue 4: relief from retrospective application

31. The ED proposes retrospective application for the proposed amendment to IAS 16. Regarding this, some respondents (CL 5, CL 18, CL 37, CL 40, CL 66) are concerned that full retrospective application:
- (a) is sometimes difficult to achieve because it would imply costly changes to current reporting systems. For example, some note that there may be cases where the servicing equipment may include a large number of

low-value items, and full retrospective application would be too onerous;
and

(b) triggers changes in important key measurements (such as EBITDA).

32. In consequence, they think that the Board should consider the need for relief from full retrospective application and propose instead, prospective application for the proposed amendment.

Staff analysis and recommendation on Issue 4

33. We think that our proposed simplification of the wording (see Issue 1) would alleviate respondents' concerns about retrospective application.
34. We think that, when this proposed amendment to paragraph 8 results in a change in the classification of servicing equipment, an entity should apply the general guidance in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (ie retrospective application). Consequently, we do not think that the Committee should address this issue.
35. The guidance in paragraphs 19(b) and 23 of IAS 8 for the application of changes in accounting policies is reproduced below (emphasis added).

19 Subject to paragraph 23:

...

(b) when an entity changes an accounting policy upon initial application of an IFRS that does not include specific transitional provisions applying to that change, or changes an accounting policy voluntarily, **it shall apply the change retrospectively**.

23 When retrospective application is required by paragraph 19(a) or (b), a change in accounting policy shall be applied retrospectively except to the extent that it is

impracticable⁴ to determine either the period-specific effects or the cumulative effect of the change.

Summary of staff recommendation and questions to the Interpretations Committee

36. We think that the Committee should recommend to the Board that it should simplify, for the sake of clarity and consistency, the proposed wording of paragraph 8 of IAS 16, as follows:

‘Items such as spare parts, stand-by equipment and servicing equipment qualify as property, plant and equipment when they meet the definition of property, plant and equipment; otherwise they are classified as inventory’.

37. Our recommended changes to the draft wording and a draft basis for conclusions are included as appendices, as follows:

- (a) **Appendix A** shows the proposed amendment, including the staff’s recommendations in this paper, highlighting differences from the currently effective standard; and
- (b) **Appendix B** shows revisions to the wording in the previously published exposure draft, following the staff’s recommendations in this paper.

⁴ Paragraph 5 of IAS 8 provides the following definition of *Impracticable*: Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

- (a) the effects of the retrospective application or retrospective restatement are not determinable;
- (b) the retrospective application or retrospective restatement requires assumptions about what management’s intent would have been in that period; or
- (c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:
 - (i) provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and
 - (ii) would have been available when the financial statements for that prior period were authorised for issue

Questions

1. Does the Committee agree to recommend to the Board that it should proceed with and simplify the proposed amendment by stating that items such as spare parts, stand-by equipment and servicing equipment that meet the definition of property, plant and equipment should be classified as such; otherwise they are classified as inventory?
2. Does the Committee agree with the proposed amendment in Appendix A? If not, what does the Committee recommend?

Appendix A—Draft wording of the proposed amendment, showing differences from the currently effective standard

Proposed amendments to IAS 16 *Property, Plant and Equipment*

Paragraph 8 is amended (new text is underlined and deleted text is struck through) and paragraph 81G is added.

Recognition

- 8 ~~Items such as spare parts, stand-by equipment and servicing equipment are often carried as inventory and recognised in profit or loss as consumed. However, major spare parts, and stand-by equipment qualify as property, plant and equipment when they meet the definition of property, plant and equipment; otherwise, they are classified as inventory. An entity expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property, plant and equipment, they are accounted for as property, plant and equipment.~~

Effective date

- 81G *Improvements to IFRSs* issued in [date] amended paragraph 8. An entity shall apply that amendment for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

Basis for Conclusions on IAS 16 *Property, Plant and Equipment*

The Basis for Conclusions accompanies, but is not part of, the proposed amendment.

Paragraph BC12A is added.

Classification of servicing equipment

- BC12A In response to a perceived inconsistency in the classification requirements for servicing equipment, the Board decided to clarify that items such as spare parts, stand-by equipment and servicing equipment qualify as property, plant and equipment when they meet the definition of property, plant and equipment, otherwise, they are classified as inventory. In the light of respondents' comments on June 2011 exposure draft, the Board did not make explicit reference to the classification of particular types of equipment, because the definition of property

plant and equipment already provides sufficient guidance. As a consequence, the Board also deleted from paragraph 8 the ‘used only in connection with’ condition on the grounds that it is too restrictive when compared with the definition of property, plant and equipment.

Appendix B—Draft wording showing changes from the exposure draft published in June 2011 following our recommendations in this paper

Proposed amendments to IAS 16 *Property, Plant and Equipment*

Paragraph 8 is amended (for ease of reference new text is underlined and deleted text is struck through) and paragraph 81G is added.

Recognition

- 8 ~~Items such as spare parts, stand-by equipment and servicing equipment are often carried as inventory and recognised in profit or loss as consumed. However, major spare parts, and stand-by equipment and servicing equipment qualify as property, plant and equipment when they meet the definition of property, plant and equipment; otherwise, they are classified as inventory an entity expects to use them during more than one period.~~
 Items such as spare parts, stand-by equipment and servicing equipment are often carried as inventory and recognised in profit or loss as consumed. However, major spare parts, and stand-by equipment and servicing equipment qualify as property, plant and equipment when they meet the definition of property, plant and equipment; otherwise, they are classified as inventory an entity expects to use them during more than one period.

Effective date

- 81G *Improvements to IFRSs* issued in [date] amended paragraph 8. An entity shall apply that amendment for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

Basis for Conclusions on IAS 16 *Property, Plant and Equipment*

The Basis for Conclusions accompanies, but is not part of, the proposed amendment.

Paragraph BC12A is added.

Classification of servicing equipment

- BC12A In response to a perceived inconsistency in the classification requirements for servicing equipment, the Board ~~proposes~~ decided to clarify that items such as spare parts, stand-by equipment and servicing equipment qualify as property, plant and equipment when they meet the definition of property, plant and equipment, otherwise, they are classified as inventory ~~servicing equipment should be classified as property, plant and equipment when it is used during more than one period and as inventory otherwise. In the light of respondents'~~

comments on June 2011 exposure draft ~~doing so~~, the Board did not make explicit reference to the classification of particular types of equipment, because the definition of property plant and equipment already provides sufficient guidance. ~~proposes to emphasise the definition of property, plant and equipment.~~ As a consequence, the Board also ~~proposes to delete~~ from paragraph 8 the ‘used only in connection with’ condition on the grounds that it is too restrictive when compared with the definition of property, plant and equipment.