

## STAFF PAPER

July 2014

## IFRS Interpretations Committee Meeting

IFRS IC March 2014

Project	Items for continuing consideration
Paper topic	IAS 16 <i>Property, Plant and Equipment</i> and IAS 2 <i>Inventories</i> 'Core inventories'—Cover note
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

## Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a request to clarify the accounting for 'core inventories'<sup>1</sup>. Core inventories are assets:
  - (a) that are physically identical to 'ordinary' inventories and as such qualify for recognition under IAS 2 *Inventories*; and
  - (b) a minimum amount of which is present in a property, plant and equipment (PP&E) item during more than one period to ensure the item's operability and as such qualify for recognition under IAS 16 *Property, Plant and Equipment*.
2. Examples of core inventories provided by the submitter include 'base' gas in a gas storage facility, pipeline fill and the permanent level of metal inventories in the metal processing industry.
3. The issue is whether core inventories should be accounted for under IAS 2 or IAS 16.

<sup>1</sup> The initial submission from ESMA is attached to [Agenda Paper 5](#) discussed at the March meeting.

4. The main consequences of the issue are:
- (a) The valuation of core inventories:
    - (i) under IAS 2: they would be measured together with ‘ordinary’ inventories using FIFO or a weighted-average cost formula; or
    - (ii) under IAS 16 (if the cost model is applied): they would be carried at historical cost less any accumulated depreciation and impairment, which results in an accounting treatment similar to that achieved using a LIFO cost formula.
  - (b) The pattern of recognition of ‘unrecoverable’ core inventories as an expense:
    - (i) under IAS 2: they would be recognised close to the end of the production facility useful life as the cost of the last load; or
    - (ii) under IAS 16: they would be recognised on a systematic basis over the useful life of the production facility.
5. The Interpretations Committee discussed the issue at its March meeting and tentatively decided to develop an interpretation to address the existing diversity in practice.<sup>2</sup>

### **Label to be used in the interpretation**

6. We think that the interpretation should use a label that is different from the term ‘core inventories’ used in the submission. This is because as the term ‘core inventories’ is sometimes used to describe fact patterns that differ from the ones to be addressed by the interpretation. It could also be misleading to refer to an item as ‘inventory’ when it is classified as an element of PP&E cost.
7. We propose to use the label ‘minimum fill’ in the interpretation. Alternatives that we considered, but rejected, were ‘minimum primer’, ‘minimum technically

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<sup>2</sup> Paper 4B documents the additional analysis we performed in respect of the existing diversity in practice.

required items/assets’, ‘minimum levels items/assets’ and ‘minimum technical stocks’.

### **Objective of Agenda Papers 4, 4A and 4B**

8. The objective of the Agenda Papers 4, 4A and 4B is to:
  - (a) summarise previous discussions (Agenda Paper 4);
  - (b) propose the scope of what is considered to be ‘minimum fill’ (Agenda Paper 4A); and
  - (c) analyse the applicability of the ‘minimum fill’ concept to a range of industries (Agenda Paper 4B).
9. To meet its objective, this Agenda Paper deals with:
  - (a) a summary of previous discussions, including decisions taken by the Interpretations Committee and the feedback from consultations with IASB members;
  - (b) an analysis of the concerns raised; and
  - (c) reconsideration of the issue against the agenda criteria
  - (d) questions to the Interpretations Committee.

### **Previous discussions**

#### ***Decisions taken by the Interpretations Committee at its March 2014 meeting***

10. The Interpretations Committee discussed the issue at its March meeting and acknowledged that there was diversity in practice. In response to that diversity in practice, the Interpretations Committee tentatively decided to develop an Interpretation and directed the staff to:
  - (a) clearly define the scope of ‘minimum fill’; and
  - (b) analyse the applicability of the ‘minimum fill’ concept to a range of industries.

11. Subject to elaboration of the scope of minimum fill, the Interpretations Committee supported the staff recommendation that minimum fill should be accounted in accordance with IAS 16.

***Feedback from consultations with IASB members***

12. We consulted IASB members at various meetings in April 2014 to inform them of the tentative decision to develop an interpretation taken by the Interpretations Committee and to obtain their individual views on this issue. We did not ask the IASB members to make any decisions when we consulted them.
13. The feedback that we received from those consultations can be summarised as follows:
- (a) Many of the IASB members consulted expressed a view that classification under IAS 16 would be appropriate only for items for which the carrying amount cannot be principally recovered through immediate sales (or consumption by the entity).
  - (b) The IASB members consulted raised the following concerns about the classification of minimum fill under IAS 16 *Property, Plant and Equipment*:
    - (i) Some of the IASB members noted that in many cases minimum fill is physically substituted by ordinary inventories on a continuous basis and as such it is subsequently sold. This would suggest that it should be accounted for as inventories.
    - (ii) A small number of IASB members also expressed a view that minimum fill causes an item of PP&E to operate rather than bringing it to the condition of being capable of operating.
    - (iii) Several IASB members expressed concern that accounting for minimum fill under IAS 16 could result in accounting treatment similar to that achieved using a LIFO cost formula.

- (iv) A small number of IASB members thought that if minimum fill was accounted for using IAS 16, then in circumstances in which it was continuously being ‘replaced’, such as in a pipeline, its components would continually be derecognised and replaced with new minimum fill amounts. They thought that this would have the same accounting effect as applying a FIFO inventory measurement approach.
- (c) Some IASB members did not express support for developing an interpretation on the issue, for the following reasons:
  - (i) A small number of IASB members raised a concern about whether the issue is expected to have a material effect on those affected.
  - (ii) A small number of IASB members expressed a view that the issue should not be addressed because the IFRSs are principle-based Standards.
  - (iii) One IASB member raised a concern that the interpretation could be applied to a broader range of circumstances than intended, eg the definition of ‘capable of operating’ could be extrapolated to other facts and circumstances. Consequently that IASB member thought that a narrow-scope amendment would be better than an Interpretation, in order to avoid unintended consequences.

IASB members also noted that if an interpretation were to be developed, the key objective would be to define the scope of ‘minimum fill’ and that further analysis based on particular examples could be needed.

## **Analysis of the concerns raised**

### ***Concerns about classification of minimum fill under IAS 16***

14. The concerns raised by IASB members prompted us to look very carefully at the scope of the term ‘minimum fill’. The comments made caused us to consider

whether the scope of the term should be limited only to items for which the carrying amount is not expected to be recovered principally through sales (or consumption by the entity)<sup>3</sup>. Consequently, we are proposing to define minimum fill as a constant level of inventories for which the carrying amount is not expected to be recovered at the end of its useful life principally through its sale or consumption in the production process or in the rendering of services. Please see Agenda Paper 4A for our analysis that led us to this conclusion.

**Concerns about addressing the issue through an interpretation**

15. In response to the concerns raised by IASB members on whether the issue is expected to have a material effect, we considered different examples of minimum fill in a range of industries (refer to Agenda Paper 4B). On the basis of our analysis of the feedback we received from our outreach, we think that the issue would have a material effect on the oil and gas industry (‘base’ gas in a gas storage facility and pipeline fill) and on the metal processing industry (permanent level of metal inventories in a refinery).<sup>4</sup>

**Reconsideration of the issue against the agenda criteria**

16. We reconsidered our assessment of the issue against Interpretations Committee agenda criteria based on the additional analysis of the existing practices<sup>5</sup>. Our assessment against the Interpretations Committee agenda criteria<sup>6</sup> is as follows:

Agenda criteria	
We should address issues:	
that have widespread effect and have, or are expected to have, a material effect on those affected.	Yes, the issue is widespread. It is expected to have a material effect on some industries, ie the oil and gas and metal processing industries. <sup>5</sup>

<sup>3</sup> Refer to Agenda Paper 4A, in particular to paragraph 36.

<sup>4</sup> We are proposing to change the practice of accounting for minimum fill in those industries.

<sup>5</sup> Refer to Agenda Paper 4B.

<sup>6</sup> As presented in paragraphs 5.16, 5.17 and 5.21 of the [IFRS Foundation Due Process Handbook](#).

Agenda criteria	
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods.	Yes, diversity in practice was identified in the oil and gas and metal processing industries.
that can be resolved efficiently within the confines of existing IFRS and the <i>Conceptual Framework for Financial Reporting</i> .	Yes
In addition:	
Is the issue sufficiently narrow in scope so that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRS?	Yes
Will the solution that was developed by the Interpretations Committee be effective for a reasonable time period?	Yes

17. We continue to recommend that an interpretation should be developed to address this issue.

### Questions for the Interpretations Committee

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<ol style="list-style-type: none"> <li>1. Does the Interpretations Committee have any questions on the feedback from consultations with IASB members?</li> <li>2. Taking into account the concerns raised by IASB members and the reassessment of the issue against the agenda criteria, does the Interpretations Committee continue to agree with our recommendation to address this issue through an interpretation?</li> <li>3. If yes, does the Interpretations Committee agree with the staff recommendation on the label to be used in the interpretation ('minimum fill')? If not, what alternative do you recommend?</li> </ol>