STAFF PAPER

July 2014

IFRS Interpretations Committee Meeting

IFRS IC March 2014

Project	**Items for continuing consideration**		
Paper topic	IAS 16 *Property, Plant and Equipment* and IAS 2 *Inventories* ‘Core inventories’—Scope of the interpretation		
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Introduction

1. As mentioned in Agenda Paper 4, at its March 2014 meeting, the IFRS Interpretations Committee (the Interpretations Committee) requested the staff to define the scope of what is considered to be ‘minimum fill’ (what the submitter referred to as ‘core inventories’) and to analyse the applicability of the concept to a range of industries.

2. In response to this request, this Agenda Paper proposes a scope for the term ‘minimum fill’.

3. The structure of this Agenda Paper is as follows:

   (a) description of the issue;

   (b) existing guidance in the Standards;

   (c) application of the existing guidance to each type of minimum fill and a staff proposal;

   (d) summary of staff recommendations; and

   (e) a question for the Interpretations Committee.

Description of the issue

4. The issue is which Standard (IAS 2 *Inventories* or IAS 16 *Property, Plant and Equipment*) should be applied to items that:

   (a) meet the definition of inventories in accordance with paragraph 6 of IAS 2 because they are physically identical to and commingled with inventories held for sale in the ordinary course of business or for consumption in a production process; and

   (b) meet the definition of a PP&E item in accordance with paragraph 6 of IAS 16 because they represent a constant level of inventories that is:

      (i) held for use in the production or supply of goods or services, or for rental to others; and

      (ii) expected to be used during more than one period.

5. At the Interpretations Committee meeting in March, part of our focus was on the fact that such items are needed to bring another PP&E asset to the condition necessary for it to be capable of operating (and on the relevant guidance in paragraph 16(b) of IAS 16). However, after analysing the issue further, as described in this Agenda Paper, we have identified that it is not necessary to focus on this particular guidance. We note that the same issue could arise in respect of any asset that meets the definition of a PP&E item in paragraph 6 of IAS 16, irrespective of whether it is necessary to make a production facility operational or not. Consequently, in this Agenda Paper, our analysis focuses on whether core inventories are held for use in the production or supply of goods or services, or for rental to others, and are expected to be used during more than one period.

6. We think that this broader focus would address the concerns raised by some IASB members that minimum fill cause another PP&E item to operate rather than bringing it to the condition of being capable of operating[1].

[1] Refer to Agenda Paper 4 for full details.

Description of minimum fill

7. The key characteristic of such items is that a minimum constant level of inventories is required in the production or supply of goods or services, or for rental to others (eg to pressurise a gas storage facility). As such, the minimum level of inventories of the same quantity, characteristics and use is always in the production facility, whether these inventories are comingled with other inventories or not.

8. Consequently, we think that this part of the inventories (the minimum fill) should be looked at collectively, ie as if it were a single item. This is notwithstanding the fact that in many circumstances the minimum fill is constantly refreshed.

Types of minimum fill

9. Agenda Paper 4B sets out a number of examples of minimum fill. On the basis of these examples, we identified the following two types of such items depending on the recoverability of the carrying amount of the last load. As noted above, in many circumstances the minimum fill is constantly refreshed. We refer to the very last minimum fill at the end of the life of the PP&E as the 'last load'.

    (a) *'Unrecoverable' minimum fill*—for which the carrying amount of the last load cannot be recovered principally through sale (or consumption by the entity).

        As such, unrecoverable minimum fill could be described as a constant level of inventories, when looked at collectively, for which the carrying amount is not expected to be recovered at the end of its useful life principally through its sale (or consumption by the entity).

    (b) *'Recoverable' minimum fill*—for which the carrying amount of the last load can be recovered principally through sales (or consumption by the entity) at the end of its useful life.

        As such, recoverable minimum fill could be described as a constant level of inventories, when looked at collectively, for which the carrying amount is expected to be recovered principally through sales (or consumption by the entity), rather than through continuing use.

10. We analyse the accounting for these two types of the minimum fill separately in the section *Application of the existing guidance* below.

Existing guidance in the Standards

Guidance in IAS 16

11. Paragraph 6 of IAS 16 provides the following definition of PP&E:

> *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.

Guidance in IAS 2

12. Paragraph 6 of IAS 2 *Inventories* provides the following definition of inventories:

> 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.

13. Paragraph 35 of IAS 2 states that:

> Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way is recognised as an expense during the useful life of that asset.

Guidance in IFRS 5 Non-current Assets Held for Sale and Discontinued Operations (and consequent amendments to IAS 16)

14. Paragraph 6 of IFRS 5 states that (*emphasis* added):

> An entity shall classify a non-current asset (or disposal group) as held for sale if its *carrying amount will be recovered principally* through a sale transaction rather than through continuing use.

15. Consequent amendments to IAS 16 were made. In particular, paragraph BC32 of *Basis for Conclusions on IAS 16* was added to describe that (*emphasis* added):

> In July 2003 the Board published ED 4 *Disposal of Non-current Assets and Presentation of Discontinued Operations*. ED 4 was published as part of the Board's short-term convergence project, the scope of which was broader than that of Improvement project. In ED 4, the Board proposed that an entity should classify some of its assets as 'assets held for sale' if specified criteria are met. Among other things the Board proposed that an entity should cease depreciating an asset classified in this manner, irrespective of whether the asset is idle. *The basis for this proposal was that the carrying amount of an asset held for sale will be recovered principally through sale rather than future operations, and therefore accounting for the asset should be a process of valuation rather than allocation.* The Board will amend IAS 16 accordingly when ED 4 is finalised.[2]

[2] Consequently, paragraph 55 of IAS 16 was amended to read as follows:

> Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 and the date that the asset is derecognised. Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated.

Guidance in the Conceptual Framework for Financial Reporting

16. Paragraph 4.4(a) of the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*) defines an asset as follows:

> An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

17. Paragraph 4.8 of the *Conceptual Framework* states that (an extract below):

> The future economic benefits embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity.

18. Paragraph 4.51 of the *Conceptual Framework* quoted below provides general guidance on the recognition of expenses:

> When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as property, plant, equipment, goodwill, patents and trademarks; in such cases the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

Application of the existing guidance to each type of minimum fill

19. We present our analysis separately for 'unrecoverable' and 'recoverable' minimum fill[3].

[3] The notions of recoverable minimum fill and unrecoverable minimum fill are described in paragraph 9 above.

'Unrecoverable' minimum fill

20. The 'unrecoverable' minimum fill is constantly held for use, and is not expected to be sold or consumed by the entity. As such, we think that it does not meet the definition of inventories in paragraph 6 of IAS 2. However, it meets the definition of PP&E in paragraph 6 of IAS 16, because it is held for use in the production process and is expected to be used during more than one period.

21. Consequently, we think that the draft interpretation should propose that unrecoverable items (a constant level of inventories, when looked at collectively, for which the carrying amount is not expected to be recovered at the end of its useful life principally through its sale or consumption by the entity) be included within the scope of the term 'minimum fill', and be accounted for in accordance with IAS 16.[4]

'Recoverable' minimum fill

22. We think that recoverable minimum fill could be considered to meet both the definition of a PP&E asset as an asset that is expected to be used during more than one period, and the definition of inventories as an asset held for sale (or for consumption by the entity).

23. In order to understand how the existing guidance should be applied to these particular circumstances, we analysed the requirements in IFRS dealing with similar and related issues and the general principles in the *Conceptual Framework*. In particular, we considered the following guidance that we think would be relevant in this case:

    (a) guidance in IFRS 5 (and consequent amendments to IAS 16), which makes a distinction between assets held for continuing use and assets held for sale; and

    (b) the definition of an asset and the principles in the *Conceptual Framework* for recognition of expenses.

[4] We will analyse what guidance on application of the principles of IAS 16 to the particular items, if any, should be included in the draft interpretation. We will present our analysis at a future meeting.

IFRS 5 (and consequent amendments to IAS 16)

24. The definition of non-current assets held for sale in paragraph 6 of IFRS 5 highlights the difference between assets held for sale and assets held for continuing use. The Standard requires an entity to consider how the carrying amount of assets is principally recovered:

> An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

25. This distinction is also reflected in BC 32 of the *Basis for Conclusions on IAS 16*. This paragraph further states that if the carrying amount of an asset is recovered principally through its sale rather than through future operations, accounting for such an asset should be a process of valuation rather than of allocation, and the asset should therefore be reclassified out of the PP&E category.

26. We think the same principle should be applied by analogy to distinguish between PP&E and inventories.

The Conceptual Framework

27. The definition of an asset in the *Conceptual Framework* also considers the way in which the economic benefits embedded in the asset are consumed. It implies that accounting for an asset should depict economic benefits embodied in the asset, ie “the potential to contribute to the flows of cash and cash equivalents to the entity”.

28. Consequently, we think that in order to determine the classification of the recoverable minimum fill, an entity should consider the way in which the economic benefits embodied in the asset are expected to flow to the entity, ie the way in which the carrying amount of the asset is expected to be principally recovered. This would probably lead to recoverable minimum fill being classified as inventories and accounted for in accordance with IAS 2.

29. If the same classification criterion is applied to unrecoverable minimum fill, this would not change its proposed accounting treatment described above. This is because the carrying amount of the unrecoverable minimum fill is not expected to

be recovered principally through sales (or consumption by the entity). Consequently, it would be classified as PP&E in accordance with IAS 16.

Staff proposal

30. On the basis of the analysis above, we propose to define the 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. We think that items meeting the definition of minimum fill would be accounted for in accordance with the principles of IAS 16[5].

31. In order to apply the definition above to a particular item, an entity would need to assess the recoverability of the carrying amount of that item. That classification should be made on recognition; consequently we think that the assessment of the recoverability of the item:

    (a) should be based on the current price of items at the date of recognition, ie expected price fluctuations should not be considered in assessing whether the cost of minimum fill is expected to be recovered principally through sale. This approach is consistent with the guidance on residual value in paragraph 6 of IAS 16 (quoted below):

    > The residual value of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

    (b) should consider the estimated costs of disposal of the minimum fill. The consequence of considering the costs of disposal is that if the expected cost of extracting the minimum fill from the PP&E is more than the expected sales proceeds receivable from its subsequent sale, then its carrying amount cannot be recovered principally through sale.

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[5] We will analyse what guidance on application of the principles of IAS 16 to the particular items, if any, should be included in the draft interpretation. We will present our analysis at future meetings.

Generic examples

32. Agenda Paper 4B sets out a number of examples of minimum fill and the conclusions drawn from those examples. We highlight some of those conclusions in the paragraphs below (refer to Agenda Paper 4B for full details).

33. Agenda Paper 4B provides the following example of the items that we think would be included in the scope of what is considered to be 'minimum fill':

    (a) an 'unrecoverable' portion of 'base' gas in gas storage facilities, for which the carrying amount is not expected to be recovered principally through its sales (or consumption by the entity)[6];

    (b) nuclear fuel rods in nuclear power plant that are expected to be used during more than one period; and

    (c) catalysts that are expected to be used during more than one period.

34. Such items as 'recoverable' portion of base gas, pipeline fill, non-current ore and metals in process in the mining industry and constant levels of metal inventories in a refinery would be excluded from the scope of the interpretation, if their carrying amount is expected to be recovered principally through sales at the end of the useful life of the production facility (or at an interim date).

35. The minimum amount of inventories held for legal or national security purposes would also be excluded from the scope of the interpretation, because its carrying amount can be recovered principally through sales at a certain point in time, and an equivalent quantity is not necessarily maintained over the PP&E's useful life.

Summary of staff recommendation

36. We think that the interpretation should address accounting for the minimum fill—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.

[6] Generally the base gas can be physically recovered from salt caverns and cannot be physically recovered from aquifers, based on the feedback we received. Refer to Agenda Paper 4B for full details.

37. We think that minimum fill should be recognised in accordance with the principles of IAS 16. We also think that the constant level of inventories, for which the carrying amount is expected to be recovered at the end of its useful life principally through sale or consumption in the production process or in the rendering of services, should be recognised in accordance with the principles of IAS 2.

Question for the Interpretations Committee

Question for the Interpretations Committee
Does the Interpretations Committee agree with the staff recommendation on the scope and the key principle of the interpretation as defined in paragraphs 36 and 37 above? If not, what alternative do you recommend?