

## STAFF PAPER

15-16 July 2014

## IFRS Interpretations Committee Meeting

<b>Project</b>	<b>IAS 16 <i>Property, Plant and Equipment</i></b>		
<b>Paper topic</b>	Accounting for net proceeds and costs of testing on PPE		
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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 accounting for net proceeds received during the course of testing an item of property, plant and equipment (PPE), in the case that the net proceeds exceed the costs of testing.

## Paper structure

2. This paper is organised as follows:
  - (a) submission received;
  - (b) extracts from the Standards
  - (c) staff analysis of the issue;
  - (d) assessment against the interpretations agenda criteria; and
  - (e) staff recommendation.

## Submission received

3. The submission describes a situation in which the ‘revenue from production when testing the plant’ exceeds the ‘direct production cost when testing the plant during the period’. The submitter has asked whether the amount by which the revenue received exceeds the costs should be recognised in profit or loss or as a deduction from the cost of the PPE.

4. The submitted fact pattern is as follows:

Revenue from production when testing the plant during the period	CU1,177 million
Direct production cost when testing the plant during the period	CU1,038 million
Net income from testing activities	CU139 million

In this case, direct production cost when testing the plant during the period is CU 1,038 million, while revenue from production when testing the plant during the period is CU 1,177 million. Consequently the revenue from production when testing the plant is higher than the direct production cost by CU 139 million.

5. The submitter observes instances in which the difference (CU139 million) is credited to ‘assets under construction’ by some entities, because paragraph 17(e) of IAS 16 *Property, Plant and Equipment* puts no ceiling on the use of net proceeds from selling items produced during the testing activities.
6. The submitter argues that the use of the net proceeds from selling items produced should be deducted only from the cost of testing, instead of deducting from other costs of ‘assets under construction’. The submitter goes on to suggest that ‘any excess over the cost of testing should be recognized in profit or loss for the period’.
7. During the subsequent communication with the submitter, the submitter also expressed concern about the lack of disclosure requirements about how the net proceeds from selling items produced and the testing costs are accounted for.
8. The submission is reproduced in Appendix A in its entirety, except to remove the name of the submitter.

## Extracts from the Standards

9. Paragraph 16 of IAS 16 describes the elements of cost of an item of PPE. Paragraph 16(b) notes that the nature of the directly attributable costs that should be included in the carrying amount of PPE are necessary costs (emphasis added):

16 The cost of an item of property, plant and equipment comprises:

- (a) ...
- (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.

10. Paragraph 17 of IAS 16 presents the examples of directly attributable costs, including costs of testing, to see whether the PPE is functioning properly (see paragraph 17(e) of IAS 16). In addition, it states that the net proceeds from selling any items produced while bringing the asset to that location and condition (the ‘net proceeds’) are deducted from the costs of testing (emphasis added):

17 Examples of directly attributable costs are:

- (a) ...
- (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

11. Paragraph 20(a) of IAS 16 explains that the cost incurred after the PPE is in the location and condition necessary for it to be capable of operating in the manner intended by management should not be included in the carrying amount of the PPE. For example, costs incurred when the PPE is operated at less than full capacity are not included in the carrying amount of the PPE (emphasis added):

20 Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be

capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item is not included in the carrying amount of that item. For example, the following costs are *not* included in the carrying amount of an item of property, plant and equipment:

- (a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or *is operated at less than full capacity*;

12. Paragraph 21 of IAS 16 states that income and expenses of operations that are not necessary to bring the PPE to the location and condition necessary for it to be capable of operating in the manner intended by management should be included in profit or loss (emphasis added):

21 *Some operations* occur in connection with the construction or development of an item of property, plant and equipment, but *are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management*. These incidental operations may occur before or during the construction or development activities. 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*.

13. Paragraph 55 of IAS 16 states that depreciation begins when the PPE is ‘available for use’, in other words, ‘when it is in the location and condition necessary for it to be capable of operating in the manner intended by management’ (emphasis added):

- 55 Depreciation of an asset begins when it is *available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.*

### Staff analysis of the issue

14. We noted that the wording used on the submission and the standards are not identical. The submission states that ‘revenue from production when testing the plant during the period’ whereas, paragraph 17 (e) states that ‘the net proceeds from selling any items produced while bringing the asset to that location and condition.’ The following analysis is based on the wording used in the standard.

#### ***The net proceeds from selling items produced while bringing the asset to that location and condition***

15. Paragraph 17 (e) of IAS 16 explains that the net proceeds from selling items produced while bringing the asset to that location and condition should be deducted from the cost of testing. The example given in paragraph 17 (e) is samples produced when testing equipment.
16. We note that there are two terms used in this guidance;
- (a) *Net proceeds* from selling items produced while bringing the asset to the location and condition where it will be capable of operating in the manner intended by management; and
  - (b) *The costs of testing* whether the asset is functioning properly
17. We note that the way in which paragraph 17(e) is written, it is only the costs of testing that are permitted to be included in the cost of the PPE item. We further note that these costs are reduced by the net proceeds from selling items produced during testing. We think that it is self-evident from paragraph 17(e), that if the net proceeds exceed the costs of testing, that those excess net proceeds cannot be included in the cost of the asset. We think that those excess net proceeds must therefore be included in profit or loss.

18. We further note that the costs of testing are limited to those arising from testing *whether the asset is functioning properly*. We note also that the example given in paragraph 17(e) is that of *samples* produced. From this we would expect the testing activity to be limited to that needed to confirm proper functioning, and thus the costs that can be capitalised to be similarly limited. Consequently we would not expect extensive production of goods from the asset during the testing phase.

***Proceeds from operation that is not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management***

19. The guidance in paragraph 21 of IAS 16 indicates that, proceeds and related costs that are from an operation that is not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management, that proceeds and costs should be recognised in profit or loss.
20. We note that the testing of the asset that we are discussing is part of the procedures required to bring the asset to the location and condition necessary for it to be capable of operation in the manner intended by management. We think that this guidance supports our observation above that net proceeds in excess of the costs of testing should be included in profit or loss.

***The agenda decision made in 2011***

21. In July 2011, the Interpretations Committee issued an agenda decision on a related issue. That issue focused principally on the requirement that the assessment of whether an asset is in the location and condition necessary for it to be capable of operating in the manner intended by management be performed separately for each asset.
22. We think that this agenda decision is consistent with our analysis above that the net proceeds are used only to reduce the costs of testing the asset (emphasis added):

The Interpretations Committee received a request to clarify the accounting for sales proceeds from testing an asset before it is ready for commercial production. The submitted fact pattern is that of an industrial group with several autonomous plants being available for use at different times. This group is subject to regulation that requires it to identify a 'commercial production date' for the whole industrial complex.

...

The Committee noted that paragraph 17(e) of IAS 16 applies separately to each item of property, plant and equipment. It also observed that the 'commercial production date' referred to in the submission for the whole complex was a different concept from the 'available for use' assessment in paragraph 16(b) of IAS 16. The Committee thinks that the guidance in IAS 16 is sufficient to identify the date at which an item of property, plant and equipment is 'available for use' and, therefore, is sufficient to distinguish *proceeds that reduce costs of testing an asset* from revenue from commercial production.

As a result, the Committee does not expect diversity to arise in practice and therefore decided not to add this issue to its agenda.

### ***Disclosure of the net proceeds and costs of testing***

23. The submitter also expressed concern about the lack of disclosure requirements about how the net proceeds from the selling items produced and the testing costs are accounted for.
24. We do not think that specific additional disclosure requirements are needed in relation to the net proceeds and the costs of testing. We think that if the net proceeds and costs are material, paragraph 17(c) of IAS 1 *Presentation of*

*Financial Statements* would require the disclosure of the net proceeds and the costs of testing. Paragraph 17(c) of IAS 1 states that a fair presentation requires an entity to provide additional information when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions:

- 17 In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs. A fair presentation also requires an entity:
- (a) ...
  - (c) to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity’s financial position and financial performance.

### Assessment against the interpretations agenda criteria

<b>Agenda criteria</b>	
We should address issues (5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected.	<b>TBD.</b> We are waiting for the outreach result.
whereby financial reporting would be improved through the elimination, or reduction, of diverse reporting methods.	<b>No.</b> We think that the existing paragraphs 17(e) of IAS 16 and 17(c) of IAS 1 provide sufficient guidance.
that can be resolved efficiently within the confines of existing Standards and the <i>Conceptual Framework for Financial Reporting</i> .	<b>Not applicable.</b> We think that the existing paragraphs 17 (e) of IAS 16 and 17(c) of IAS 1 provide sufficient guidance.
In addition:	
Is the issue sufficiently narrow in scope 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 (5.17)?	<b>Not applicable.</b> We think that the existing paragraphs 17 (e) of IAS 16 and 17(c) of IAS 1 provide sufficient guidance.



<b>Agenda criteria</b>	
<p>Will the solution developed by the Interpretations Committee be effective for a reasonable time period (5.21)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified).</p>	<p><b>Yes.</b> The issue does not relate to a current or planned IASB project.</p>

### **Staff recommendation**

25. We recommend that the Interpretations Committee should not take this issue onto its agenda, because we think that the existing paragraph 17(e) of IAS 16 is sufficient to require that the net proceeds of testing should be deducted only from the costs of testing. In addition, if the net proceeds of testing exceed the costs of testing, we think that the excess should be recognised in profit or loss in accordance with paragraph 21 of IAS 16.
26. We also consider that an additional disclosure requirement is not necessary. If the net proceeds and the costs of testing are material, we think that paragraph 17(c) of IAS 1 would require additional disclosure for those circumstances if this was necessary to enable users to understand the impact of the testing on the financial statements.

#### **Questions for the Interpretations Committee**

1. Does the Interpretations Committee agree that the net proceeds of testing should be deducted only from the costs of testing, and that any excess net proceeds should be recognised in profit or loss?
2. Does the Interpretations Committee agree with the staff's recommendation that the Interpretation Committee should not take this issue onto its agenda?
3. Does the Interpretations Committee have any comments on the proposed wording in Appendix A for the tentative agenda decision?

## Appendix A—Proposed wording for tentative agenda decision

A1. The proposed wording for the tentative agenda decision is presented below.

### **IAS 16 Property, Plant and Equipment— Accounting for proceeds and costs of testing on PPE**

The IFRS Interpretations Committee (the 'Interpretations Committee') received a request to clarify accounting for the net proceeds from selling any items produced while bringing an item of property, plant and equipment (PPE) to the location and condition necessary for it to be capable of operating in the manner intended by management. The submitter has asked whether the amount by which the net proceeds received exceed the costs of testing should be recognised in profit or loss or as a deduction from the cost of the PPE. The submitter also expressed concern about the lack of disclosure requirements about the accounting for the net proceeds from selling items produced and the costs of testing.

The Interpretations Committee noted that paragraph 17(e) of IAS 16 *Property, Plant and Equipment* states that the net proceeds from selling any items produced while bringing the asset to that location and condition necessary for it to be capable of operating in the manner intended by management is deducted from the costs of testing, rather than from the total cost of the asset. The Interpretations Committee also noted that any net proceeds in excess of the costs of testing should be recognised in profit or loss, in accordance with paragraph 21 of IAS 16.

The Interpretations Committee considered that an additional disclosure requirement is not necessary for the net proceeds and the costs of testing. If the net proceeds and the costs of testing are material, paragraph 17(c) of IAS 1 *Presentation of Financial Statements* would require additional disclosure if that information is necessary to enable users to understand the impact on the financial statements.

The Interpretations Committee considered that in the light of its analysis of the existing IFRS requirements, IAS 16 and IAS 1 contain sufficient guidance and neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Interpretations Committee [decided] not to add the issue to its agenda.

## Appendix B—Original agenda request

B1. The IFRS Interpretations Committee received a request to clarify accounting for proceeds and cost of testing on property, plant and equipment as follows:

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#### 1. Excerpts from IAS16:

##### Elements of cost

16 The cost of an item of property, plant and equipment comprises:

- (a)
- (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)

17 Examples of directly attributable costs are:

- (a) ...;
- (b) ...;
- (c) ...;
- (d) ...;
- (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)

#### 2. The Issue:

Paragraph 17 (e) causes variations in application in industries (such as petrochemicals) where "the net proceeds from selling any items produced while bringing the asset to that location and condition." materially exceeds the cost of testing. Some companies credit the constructed asset with net proceeds in excess of cost of testing.

**Example:** one petrochemical reported the following:

Revenue from production when testing the plant during the period:	CU 1,177 million
Direct production cost when testing the plant during the period:	CU 1,038 million
Net income from testing activities:	CU 139 million

The difference (139 million) was credited to "assets under construction". In other words, the company offsets other costs of construction that are not attributable to testing. That is because IAS 16 para. 17(e) puts no ceiling on the use of the proceeds from selling items produced during the testing activities.

**3.Suggestion:**

Limiting the use of the proceeds from selling items produced when testing equipment to offsetting of the cost of testing only. Any excess over the cost of testing should be recognized in profit or loss for the period.