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STAFF PAPER

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Project	IAS 16 *Property, Plant and Equipment*		
Paper topic	Accounting for proceeds and cost of testing PPE: should net proceeds reduce cost of asset?		
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Introduction

1. The IFRS Interpretations Committee (the 'Interpretations Committee') received a request to clarify the 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.

2. In November 2014, the Interpretations Committee decided to add this item to its agenda to analyse this issue further. The following issues were identified to be considered:

   (a) when the asset is available for use;

   (b) what costs qualify as costs of testing, while bringing the asset to that location and condition;

   (c) how to treat the proceeds in excess of the costs of testing;

(d) how to account for other proceeds received on other activities (that are not testing) that are necessary to bring the asset to that location and condition;

(e) disclosure of proceeds deducted from assets; and

(f) applicability of IFRS 15 to the proceeds received.

Summary of outreach

3. Four stakeholders have been contacted for outreach to supplement the outreach conducted before the November 2014 Interpretations Committee meeting: a preparer in the extractive industry; a preparer in the electricity generating industry, an industry group of oil and gas producers and IFRS Discussion Group of Canadian accounting standard setter. We summarise the results of the outreach in agenda paper 03A.

Issues identified through the outreach

4. On the basis of the additional outreach that we have conducted, we noted that preparers are facing challenges in applying the Standards in relation to the judgements of when the asset is capable of operating in the manner intended by management. We also note that the judgement of when the asset is capable of operating in the manner intended by management is connected to the judgements on how an entity identifies the asset and its components.

5. We identified the following issues in relation to the judgement of when the asset is capable of operating in the manner intended by management:

(a) judgement on 'capable of operating in the manner intended by management';

(b) accounting for pre-commissioning revenue, other than testing revenue; and

(c) judgement on the commencement of the production phase in the mining industry and consequently when IFRIC 20 should be applied.

6. We also identified the following issues in relation to the identification and componentisation of the asset:

   (d) Identification and componentisation of the asset in a vertically integrated asset group; and

   (e) capitalising costs in a vertically integrated asset group.

(a) Judgement on 'capable of operating in the manner intended by management'

7. Canadian Accounting Standards Board (AcSB) staff shared us the results of the discussions at their IFRS Discussion Group (the Discussion Group). The Discussion Group considers that the judgement on 'capable of operating in the manner intended by management' is a significant issue in various industries and thinks that there is diversity in practice. Through our outreach, we also noted that the judgement seems to have significant consequences on accounting for PPE.

8. The consistent application of the judgement may be particularly difficult for an industry in which production volume or quality varies because of the nature of the business (for example, in the mining industry, performance of a mine is dependent on the size and quality of the ore body which is not known with certainty at the start of the construction of the mine). Depending on how management determines the threshold at which the asset is 'capable of operating in the manner intended by management', peer companies in the same sector might account for the same circumstance differently and the comparability of financial statements could consequently be an issue.

(b) Accounting for pre-commissioning revenue, other than testing revenue

9. We note that IAS 16 *Property, Plant and Equipment* identifies only the proceeds from testing as a pre-commissioning revenue. It is not clear whether the recognition of other material pre-commissioning revenue was considered when IAS 16 was written, and whether the deduction of such other revenue from the cost of the asset is appropriate.

(c) Judgement on the commencement of production phase in the mining industry and consequently when IFRIC 20 should be applied

10. We note that the scope of IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* is specifically limited to the production phase of the mine. We consider that this is because, during the production phase, an entity may create both the benefit of extraction of the ore and the benefit of improved access to the ore body. This was noted in BC6 of IFRIC 20:

> BC6 The Committee decided that an entity may create two benefits by undertaking stripping activity (and incurring stripping costs). These benefits are the extraction of the ore in the current period and improved access to the ore body for a future period. The result of this is that the activity creates an inventory asset and a non-current asset.

11. Through the outreach conducted before the November 2014 Interpretations Committee meeting, we noted that the two benefits mentioned above may also arise during the development phase. In addition, we note that there is no definition of the 'development phase' and 'production phase' of a mine; there is just an observation that the development phase is before production begins. If an entity sets a high threshold for the commencement of the production phase, we think that there could be circumstances in which an entity is producing significant volume of ore during the development phase. In that case, the two benefits described in IFRIC 20 would be earned during the development phase.

(d) Identification and componentisation of the asset in a vertically integrated asset group

12. We consider that the judgement of when the asset becomes capable of operating in the manner intended by management relates to the following judgements in a vertically integrated asset group:

    (i) how to identify the asset, ie, 'the item of property, plant and equipment' (a unit of measure / account question); and

    (ii) how to componentise the asset.

13. Paragraphs 7 and 9 of IAS 16 states that judgement relates to unit of measure for recognition as follows:

> 7 The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:
>
> (a) it is probable that future economic benefits associated with the item will flow to the entity; and
>
> (b) the cost of the item can be measured reliably.
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> 9 This Standard does not prescribe the unit of measure for recognition, ie what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value.

14. Whether a mine and a processing plant are recognised as one single item or separate items could result in different accounting consequences. In the mining industry, we note that an important aspect of asset recognition relates to vertically integrated operations. Because a mine and a processing plant become available for use at different times, we consider that it is important to consider the consequences of these different dates on the accounting.

15. We also note that paragraph 43 of IAS 16 requires componentisation of fixed assets as follows:

> 43 Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

16. The respondent in the electricity generating industry provided an example of a combined cycled gas-fired power plant (CCGT), which is an asset that is first operated independently and is then subsequently operated combined with other assets with an amount of additional capitalisation cost. If the combined assets are treated as one single component, significant pre-commissioning revenue could be earned and deducted from the asset. Depending on how an entity componentises the asset group, the accounting consequences would be significantly different.

17. The staff also considers that the agenda decision made in July 2011 deals with the componentisation issue of asset groups. If the PPE is composed of a group of

assets that become available for use at different times, an 'available for use' assessment should be made for each separate item, as follows (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.
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> …
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> *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.*
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> As a result, the Committee does not expect diversity to arise in practice and therefore decided not to add this issue to its agenda.

(e) Capitalising costs in a vertically integrated asset group

18. We noted from our outreach that the depreciation expense of a mine may be allocated to a processing plant when the mine is capable of operating in the manner intended by management, while the processing plant is being tested. We understand that an entity capitalises the depreciation expense of the mine as part of the cost of the processing plant in accordance with paragraphs 48 and 49 of IAS 16, which state (emphasis added):

> 48 The depreciation charge for each period shall be recognised in profit or loss *unless it is included in the carrying amount of another asset*.
>
> 49 The depreciation charge for a period is usually recognised in profit or loss. *However, sometimes, the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the depreciation charge constitutes part of the cost of the other asset and is included in its*

carrying amount. For example, the depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories (see IAS 2). Similarly, depreciation of property, plant and equipment used for development activities may be included in the cost of an intangible asset recognised in accordance with IAS 38 *Intangible Assets*.

19. We note that the consequence of capitalising the depreciation cost of the mine (after it is capable of operating in the manner intended by management) into the cost of the processing plant before the plant is capable of operating in the manner intended by management gives a result that is similar to treating the mine and the plant as a single item. This result seems contrary to the objective of IAS 16 of accounting for each item separately.

Potential alternatives that could be further explored

20. On the basis of the analysis on the issues identified, we considered potential alternatives that could be explored. These alternatives are not necessarily mutually exclusive.

Additional guidance on the judgement 'capable of operating in the manner intended by management'

21. As pointed out by the Discussion Group of AcSB, we consider that additional clarification about when an asset 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) would be beneficial for achieving consistent application of the Standard. We consider that this judgement is fundamental, because it has a broad impact on the comparability of revenue, assets and future cost allocations (depreciation). As a preliminary analysis, we consider that there could be various factors that could be considered when developing such guidance, for example:

    (a) If material cash is earned through selling saleable products, should there be a rebuttable presumption that the asset is capable of operating in the manner intended by management?

(b) If an entity produces a material value of product (even if the production volume is less than the level expected at full production) and the quality of the product is not substantially different from the product intended by management, should there be a rebuttable presumption that the asset is capable of operating in the manner intended by management?

Disclosure requirement for revenue deducted from an asset

22. We note that pre-commissioning revenue deducted from an asset could be material to a company's operation. We think that disclosure about material amounts deducted from an asset would be triggered by the general disclosure requirements in paragraph 112 (c) of IAS 1 *Presentation of Financial Statements*. This would provide users such information that is relevant to understand the financial statements. Is there a need to add a specific disclosure requirement to IAS 16 in relation to this?

Prohibition of deducting pre-commissioning revenue from an asset

23. Paragraph 17(e) of IAS 16 states that the net proceeds from selling any items produced during the testing phase of an asset under construction should be deducted from PPE (such as sales of samples produced when testing the equipment). We think that the example given 'sales of samples' implies a low level of activity compared with normal production, whereas some of the examples we looked at during our outreach reflected a significant level of activity.

24. We also noted that US GAAP does not explicitly allow deducting pre-commissioning revenue (including testing proceeds), expect for some specific US industry guidance that expressly permits netting of proceeds (for example, certain pre-commissioning revenue for property developed for rental or sale). We are told that, in practice, pre-commissioning revenues are not deducted from assets in accordance with US GAAP unless specific industry guidance allows it. We understand that pre-commissioning revenues are recognised in the income statement in mining industry under US GAAP. Should the deduction of pre-commissioning revenue from the cost of an asset prohibited?

Expanding the scope of IFRIC 20

25. During the production phase of a surface mine, an entity may create both the benefit of extraction of the ore and the benefit of improved access to the ore body. These two benefits were a key driver for the guidance in IFRIC 20. Through our outreach, we have noted that an entity may create those two benefits before asset is in the condition necessary for it to be capable of operating in the manner intended by management. In that case, application of IFRIC 20 to the development phase could be beneficial for achieving further comparability of financial statements. Should expansion of the scope of IFRIC 20 be considered in order to address the circumstances in which an entity creates the material benefit of extraction of the ore during the development phase?

Additional guidance on identifying the item of PPE and componentising an asset

26. We note that capitalising depreciation expense within a vertically integrated asset group may have material effects on the accounting for PPE. Should guidance be developed on whether and how depreciation expense should be capitalised for assets used in a vertically integrated business?

Staff recommendation

27. We recommend to the Interpretations Committee that it should consider the issues and potential alternatives identified. On the basis of the results of the discussion at the Interpretations Committee meeting, the staff would bring further analysis and, if relevant, a proposal for an amendment/interpretation to a future meeting.

Questions for the Interpretations Committee

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1. What comments do the Interpretations Committee members have on the issues identified through the outreach? Is there any other issue that should also be considered? 2. Which of the potential alternatives does the Interpretations Committee want us to analyse further? Are there other alternatives you would like included in our analysis?