

## STAFF PAPER

May 2015

## IFRS Interpretations Committee Meeting

<b>Project</b>	<b>IAS 16 <i>Property, Plant and Equipment</i></b>
<b>Paper topic</b>	Accounting for proceeds and cost of testing PPE: should net proceeds reduce cost of asset?
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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 the net proceeds from selling any items produced while testing an item of property, plant and equipment (PPE) under construction. 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 January 2015, the Interpretations Committee observed that the analysis should focus on the meaning of ‘testing’ the PPE, because this term is used in paragraph 17(e) of IAS 16 *Property, Plant and Equipment*. The Interpretations Committee observed that the reference to ‘proceeds’ in IAS 16 is made only in relation to testing. On this basis, the appropriate question is whether the activity that led to those proceeds was testing.
3. The Interpretations Committee also observed that disclosure about this issue in the financial statements, including the judgements made by management, is important and should be considered.

## Paper structure

4. This paper is organised as follows:
  - (a) the meaning of ‘testing the PPE’;
  - (b) disclosure; and
  - (c) staff recommendation.

## The meaning of testing the PPE

### Testing in IAS 16

5. Paragraph 17(e) of IAS 16 describes the activity of testing as ‘testing whether the asset is functioning properly’:
  - 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
6. IAS 16 does not contain any other paragraphs that directly relate to the meaning of testing; however, the following paragraphs provide some clarification:
  - (a) paragraph 16(b) notes that the directly attributable costs that should be included in the carrying amount of the PPE must be ‘necessary’ for it to be capable of operating in the manner intended by management.
  - (b) 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.

- (c) 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.
- (d) paragraph 55 of IAS 16 states that the 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. We take this to mean that if the asset is already available for use; the activity would not meet the requirements of paragraph 17(e).

7. We noted that these paragraphs do not necessarily provide sufficient clarification about the meaning of ‘testing’ and thus we conducted further outreach.

***Further outreach conducted***

8. Since the last Interpretations Committee meeting, we have conducted some further outreach, focusing on the interpretation of ‘testing’ in practice. We discussed the issue at the March 2015 Global Preparers Forum (GPF). We also conducted follow-up outreach with a mining company and we contacted a former IASB staff member who was involved in the drafting of IAS 16 in 2003. The outreach is summarised in the following paragraphs.

9. GPF members commented as follows:

- (a) One GPF member observed that the guidance in paragraph 17(e) of IAS 16 could be the cause of diversity in practice and held the view that paragraph 17(e) should be simplified to be similar to US GAAP, so that no proceeds should be deducted from the cost of the PPE.
- (b) Another GPF member noted that in the extractive industries there is diversity in interpreting ‘functioning properly’ in accordance with paragraph 17(e) of IAS 16. Some companies make the assessment solely from a technical and engineering perspective, while others also consider financial aspects such as the level of net proceeds. IAS 16

implies that the assessment should be made only from the technical and engineering perspective. That GPF member also observed that the assessment is affected by how an entity componentises the PPE.

- (c) Another GPF member stated that it may take a couple of years until the PPE functions as intended by management. In that GPF member's experience, only the proceeds from the sale of output produced by the first test runs would be deducted from the cost of the asset; the proceeds received from saleable outputs are, however, usually recognised in the income statement.

10. We also conducted further outreach with a mining company.

- (a) The respondent considers that the assessment of 'functioning properly' is a purely technical assessment, eg on the basis of a chemical mixture of small samples instead of waiting for the plant to operate at designed throughput based on optimal efficiencies. From the respondent's experience, the testing period is around six weeks. If testing is extended to full ramp-up to optimal throughput levels and efficiencies, this can delay 'functioning properly' to a later date, because of external factors such as insufficient feedstock or poor chemistry of feedstock.
- (b) The respondent noted a different view for interpreting the meaning of 'functioning properly' in the extractive industry. The different interpretation also considers the financial result, for example, positive net cash flow for a specified period.
- (c) The respondent considers that componentisation of the asset can help when faced with this issue. If a mine, as a cash-generating unit (CGU), is composed of several pits, treating each as a separate component means that the income generated from one pit is recognised in profit or loss (along with appropriate depreciation or amortisation), even if other pits are still not ready for use. Identifying further that the pit may come into use prior to the material being capable of final processing, because of delays in establishing a processing plant, should not affect 'functioning properly', because IAS 16 is not a CGU measure. Some

diversity exists because of the difference in determining the ‘component’ that is deemed to be ‘functioning properly’.

- (d) The respondent considers that the diversity in practice may be affected by the practice under the previous GAAPs used in each jurisdiction, before IFRS was adopted.

11. With respect to considering this issue, the former IASB staff member involved in the revision of IAS 16 highlighted to the staff the following provisions of IAS 16, and added the comments noted:

- (a) Paragraph 7 of IAS 16 states that ‘The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:...’. In drafting IAS 16, the IASB staff did not recommend that the IASB should define the term ‘item’; instead, the staff suggested that the IASB should draft IAS 16—including its depreciation and derecognition provisions—to function regardless of how an ‘item’ was set out in a particular practice situation.
- (b) Paragraph 15 of IAS 16 states that ‘An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost’. The associated provisions of IAS 16, which set out the elements of ‘cost’ (see paragraphs 16 to 22 of IAS 16), acknowledge that proceeds may also arise in connection with the construction or development of an item of property, plant and equipment. More specifically:
  - (i) Paragraph 17(e) of IAS 16 addresses accounting for the net proceeds associated with selling any items produced *while bringing the asset to the location and condition* (emphasis added) where the asset is functioning properly. These proceeds are deducted from the cost of the item.
  - (ii) Paragraph 21 of IAS 16 addresses accounting for the income associated with operations that are *not necessary to bring an item to the location and condition* (emphasis added) necessary for it to be capable of operating in the

manner intended by management. These proceeds and their associated costs are recognised in profit or loss.

In drafting the provisions of paragraph 17(e), the IASB staff considered that there would be a certain congruence to the accounting model if the specified proceeds were not recognised in profit and loss, because during the period noted the accumulation of the cost of the item is still continuing pursuant to paragraph 15 of IAS 16, versus the depreciation of the asset having begun pursuant to paragraph 55 of IAS 16.

- (c) Paragraph 20 of IAS 16 states that ‘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, ...’ In drafting the provisions of paragraph 20 of IAS 16, the IASB staff were intending to include provisions to acknowledge that nuances may arise in deploying an item of property, plant and equipment into service; however, these nuance situations were to be accounted for pursuant to the provisions of IAS 16, and not as an exception to them.
- (d) Paragraph 55 of IAS 16 states that ‘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’. In drafting the provisions of paragraph 55, the IASB staff intended to use the same criteria (‘...when it is in the location and condition...’) to trigger the start of depreciation as is used to signal the end of cost accumulation (measurement of the cost of an item) pursuant to paragraph 15. The underlying idea was that there would not be a ‘middle ground’ phase during which an item of property, plant and equipment is neither accumulating its cost nor is subject to IAS 16’s depreciation provisions.

## **Staff analysis**

### *Nature of testing and quantity of the output*

12. Paragraph 17(e) of IAS 16 states that testing is whether the asset is ‘functioning properly’ rather than ‘operating’ at a particular pre-determined level.
13. We also note that paragraph 16(b) of IAS 16 states that the directly attributable cost is the cost that brings the asset to the location and condition necessary for it to be ‘capable’ of operating in the manner intended by management. The paragraph does not require the PPE to operate at the level necessary to produce the quantity of the output as intended by management.
14. We also note that our recent outreach has described a view that the test for proper functioning is one that focuses on the technical/physical performance of the PPE, and not on the financial performance. We agree with this view, because we think that it is consistent with the notion of assessing whether the asset is ‘functioning properly’.
15. 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. In particular, it gives the example of costs incurred when the PPE is operated at less than full capacity, which are to be excluded from the carrying amount of the PPE. We note that this too is consistent with our observations above about the nature of testing.

### *Proposed solution*

16. We have considered how we could address the issue. We do not think that an agenda decision would effectively solve the issue, because our outreach described in this paper highlights the existence of divergence in interpreting the meaning of ‘functioning properly’ in the extractive industry. In addition, the feedback received on the tentative agenda decision issued in July 2014 indicated that the

clarification of the issue would sufficiently change the practice. We consider that some form of standard-setting action is needed.

17. On the basis of our analysis of the nature of ‘testing’ described above, and the results of the outreach received, we think that the proceeds received from testing that an item of PPE is functioning properly should normally be ‘de minimis’. Consequently, we think that if the proceeds received from the sale of test production is more than de minimis, this should lead to a presumption that the operation of the PPE has moved beyond testing. The presumption should be rebutted if it can be demonstrated that the asset is not ready for use. We consider the requirements for a rebuttal below.

### *Rebutting the presumption*

18. We consider that there might be cases in which more than de minimis sale proceeds could be received while testing whether the PPE is functioning properly was still in progress.
19. However, before rebutting the presumption, we think that a reassessment of the identification and componentisation of the PPE is appropriate. We note that the feedback received highlighted concerns that the diversity observed in practice could be symptomatic of insufficient componentisation of the asset. We also note that IAS 16 does not prescribe the unit of measure and requires judgement in identifying the asset.
20. Paragraph 9 of IAS 16 states that judgement is needed with respect to the unit of measure for recognition, as follows:
- 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.
21. 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.
22. We note that the judgement on identification and componentisation of the PPE could result in different accounting consequences. We learned about an example in which a mine is composed of several pits. Our outreach suggested that, if several pits are treated as one component, the asset would not be ready for use until all the pits are ready for use. However, if each pit is identified as a separate component, then depreciation of each pit will commence when that pit is ready for use.
23. We understand from our outreach that the introduction of the concept of componentisation was intended to function regardless of how an ‘item (unit of account)’ was identified in a particular circumstance. The outreach also suggested that when the component is in the location and condition necessary for it to be capable of operating in the manner intended by management, this would trigger the start of depreciation. This is because no matter how an item is identified, the accounting reflects the same economic reality in the same way, whether the asset is identified as a large item with several components or as a group of smaller items. This highlights the importance of the componentisation assessment.
24. Having reassessed the identification and componentisation of the PPE, we think that the presumption that the asset has moved beyond the testing phase should be rebutted if the entity can demonstrate that the quality of the output is materially different from the quality intended by management. We think this would be consistent with our view, and with the views that we heard through the outreach, that the purpose of testing is to assess the technical/physical performance of the PPE.
25. We think that the following indicators may be considered when assessing the quality of the output:
- (a) whether the test product is saleable to the customers to whom the final products are planned to be sold; and

- (b) whether the prices of the test product and the final product that are planned to be sold are significantly different.

### *Implementation of proposed action*

- 26. We consider that incorporating the above rebuttable presumption into IAS 16 would provide the clarification on the meaning of testing. We think that the most straightforward way of providing clarification is to do so in IAS 16 itself.
- 27. Alternatively, if the Interpretations Committee thinks that issuing a short interpretation without changing IAS 16 would more suitable for addressing the issue, a short interpretation of the meaning of ‘functioning properly’ in paragraph 17 (e) of IAS 16 could be issued. Paragraph 20(a) of IAS 16 states that costs incurred when the PPE is operated at less than full capacity are not included in the carrying amount of the PPE. We consider that the interpretation might highlight this paragraph in relation to the meaning of ‘functioning properly’ and discuss the rebuttable presumption discussed above.
- 28. On balance, we consider that amending the Standard would be more straightforward.

## **Disclosure**

### ***Potential items for disclosure***

- 29. During the January Interpretations Committee meeting, members suggested considering disclosures to enhance the transparency of the practice, such as:
  - (a) the amount credited to assets; and
  - (b) management’s judgement in determining when the asset was capable of operating as intended.
- 30. Other members expressed a view that referring to the disclosure requirements in paragraph 17(c) of IAS 1 would be sufficient to provide transparency:

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.

### ***Disclosures made by entities***

31. The staff read 10 published financial statements from the mining industry to understand the practice:

- (a) the amount credited to the asset—the staff noted that many mining companies disclose the fact that pre-commissioning revenue is offset against the cost of the asset under construction. However, most of the financial statements read by the staff merely state the fact that the pre-commissioning revenue was offset, instead of stating the amount that has been offset.
- (b) management's judgement in determining when the asset was capable of operating as intended—the staff noted that disclosure varies regarding management's judgement in determining when the asset was capable of operating as intended. Some companies merely state that management makes judgement on commercial production. Others list the factors that managements used when making the judgements that the asset was capable of operating as intended, such as:
  - (i) the level of capital expenditures compared to the construction cost estimates;
  - (ii) the completion of a reasonable period of testing mine plant and equipment;

- (iii) the ability to produce minerals in a saleable form; and
- (iv) the ability to sustain the ongoing production of minerals.

### **Staff analysis on disclosures**

32. We think that if pre-commissioning revenue were to be deducted from the cost of the PPE, users would not understand the significance of the transaction without specific disclosure about the amount that has been offset. Accordingly, we expect that the credited amount, if it was material, would need to be disclosed in accordance with paragraph 17(c) of IAS 1.
33. Regarding management's judgement in determining when the asset was capable of operating as intended, we think that the disclosures would be most helpful if they were highly tailored to the existing circumstances; for example, by providing specific details of the judgements on specific facts and circumstances when the particular asset takes more than the normal period of time before it becomes ready for use. This would aid transparency and comparability about the judgements that had been made.

### **Conclusion**

34. We consider that the disclosures needed to provide relevant information about assets under construction can be achieved with the existing disclosure requirements in paragraph 17(c) of IAS 1. We do not consider that additional disclosure requirements need to be added to the Standards.

### **Staff recommendation**

35. We consider that the meaning of testing activity could be clarified as follows:
- (a) When the PPE produces more than de minimis saleable output, the rebuttable presumption should be made that the activity is no longer testing.

- (b) If more than de minimis sale proceeds are received but the PPE is still being tested for whether it is functioning properly, the identification and componentisation of the PPE should be reassessed. In addition, we consider that the above presumption would be rebutted when
- (i) the product is not saleable to the customers to whom the final products are planned to be sold; and
  - (ii) the prices of the testing product and the final product that are planned to be sold are significantly different.
36. We considered whether the above clarification of the meaning of testing activity could be addressed through an IFRIC interpretation of the term ‘functioning properly’ but instead we favour an amendment to IAS 16 to introduce this clarification.
37. With respect to disclosures, we consider that sufficient disclosure requirements exist in paragraph 17(c) of IAS 1 to lead to adequate disclosure of relevant information.

## Questions for the Interpretations Committee

### Questions for the Interpretations Committee

1. What comments does the Interpretations Committee have on the staff analysis on the meaning of testing and to recommend to the IASB that IAS 16 be amended as in paragraph 35 of this paper?
2. Does the Interpretations Committee agree that the disclosure requirements in paragraph 17(c) of IAS 1 should be referred to, instead of explicitly requiring additional disclosure?
3. Does the Interpretations Committee have any comment on the alternative solution of issuing a short interpretation of the meaning of ‘functioning properly’?