IFRS

STAFF PAPER

September 2016

IFRS® Interpretations Committee Meeting

Project	**IAS 16 *Property, Plant and Equipment***
Paper topic	Proceeds and costs of testing PPE: should net proceeds reduce the cost of PPE?

CONTACT(S) Raghava Tirumala rtirumala@ifrs.org +44 (0)20 7246 6953

Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a request to clarify the requirements in paragraph 17(e) of IAS 16 *Property, Plant and Equipment*. The request relates to net proceeds from selling items produced while testing an item of property, plant and equipment (PPE) under construction. The submitter asked whether an entity recognises the amount by which the net proceeds received exceed the costs of testing in profit or loss or, instead, as a deduction from the cost of the PPE.

2. In March 2016, the Interpretations Committee discussed the following approaches for the recognition of proceeds from selling items produced before an item of PPE is capable of operating as intended by management: [1]

   (a) restricting the amount of proceeds an entity deducts from the cost of PPE to only those proceeds arising from testing activities, and clarify that the net proceeds deducted should not exceed the costs of testing included as part of the cost of PPE; and

   (b) prohibiting the deduction of proceeds from the cost of PPE.

[1] See *Appendix A* to this paper for an overview of the previous discussions of the Interpretation Committee on this issue.

3. The Interpretations Committee tentatively decided to recommend to the Board that it propose a narrow-scope amendment to IAS 16. The proposed amendment would prohibit the deduction from the cost of PPE the proceeds from selling items produced before an item of PPE is capable of operating as intended by management (the approach described in paragraph 2(b) above).

4. The Interpretations Committee directed the staff to analyse:

   (a) whether existing disclosure requirements in IFRS Standards are sufficient to provide useful information in the context of the proposed amendments; and

   (b) the transition requirements relating to the proposed amendments.

5. This paper considers:

   (a) the existing disclosure requirements in IFRS Standards;

   (b) the transition requirements for the proposed amendments; and

   (c) the wording of the proposed amendments to IAS 16.

Disclosure requirements

Background

6. At its March 2016 meeting, the Interpretation Committee asked the staff to consider whether any additional disclosure requirements would be helpful. A number of members said that additional disclosures would not be needed because the sale of items produced while making PPE available for use[2] is likely to be within the scope of IFRS 15 *Revenue from Contracts with Customers*. In that case, an entity would provide the disclosures required by IFRS 15.

7. A few members expressed concern that the proposed amendments might affect the profit margins of entities, particularly of those in the extractives industry—because the profit margin on output produced before commissioning an item of

[2] For ease of reading within this paper, the phrase 'making PPE available for use' has been used to refer to 'bringing an asset to the location and condition necessary for it to be capable of operating in the manner intended by management', which are the words used in IAS 16.

PPE (such as a mine or an oil well) is unlikely to be the same as the profit margin on output produced after the PPE is commissioned. In addition, these pre-commissioning sales are not typically recurring sales. Accordingly, it may be important for an entity to disclose information about the revenue and cost of sales to help users of financial statements understand the effect on trend information.

Staff analysis and conclusion

8. When analysing whether additional disclosure requirements are necessary, we considered:

   (a) the 'items' that are generally produced while making PPE available for use; and

   (b) the disclosure requirements in IFRS Standards that apply to those items.

9. We agree with those Interpretations Committee members who observed that items produced by an item of PPE before it is available for use are likely to be output from an entity's ordinary activities. If the PPE is to be used in the entity's ordinary activities, we see no reason to conclude that output produced by that PPE before it is available for use is not output from the entity's ordinary activities. We would therefore expect the sale of output, whether produced before or after the PPE is available for use, to be within the scope of IFRS 15, unless the counterparty is not a customer. An entity accounts for the cost of that output sold applying IAS 2 *Inventories*. Consequently, an entity would disclose the information required by those Standards.[3]

10. Paragraph 114 of IFRS 15 requires the following:

> An entity shall disaggregate revenue recognised from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. An entity shall

[3] We note that paragraph 3 of IAS 2 excludes from the measurement requirements in that Standard minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries. An entity is still required to apply the disclosure requirements in IAS 2 to those mineral and mineral products held as inventory.

apply the guidance in paragraphs B87–B89 when selecting the categories to use to disaggregate revenue.

11. Paragraphs B87–B89 of IFRS 15 provide application guidance but do not prescribe the categories for disaggregation. An entity considers facts and circumstances that pertain to its contracts with customers when deciding the extent to which its revenue is disaggregated for the purposes of this disclosure.

12. The disclosures required by paragraph 36 of IAS 2 include:

    (a) the accounting policies adopted in measuring inventories, including the cost formula used;

    (b) the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;

    (c) the carrying amount of inventories carried at fair value less costs to sell; and

    (d) the amount of inventories recognised as an expense during the period.

13. Paragraphs 37–39 of IAS 2 provide application guidance on those requirements.

14. If revenue and cost of output produced while making PPE available for use has a material effect on the profitability of the entity and/or trend information, we would expect the entity to:

    (a) consider revenue from sale of that output as a category for disclosure of disaggregated revenue, applying paragraph 114 of IFRS 15. This would enable users of financial statements to understand the nature, amount, timing and uncertainty of that revenue and those cash flows.

    (b) disclose the accounting policy adopted in measuring the output, the carrying amount of the output in inventory (if any), and the cost of the output recognised as an expense, applying paragraph 36 of IAS 2.

15. We recommend not including additional disclosure requirements in the proposed amendments. Existing requirements in IFRS 15 and IAS 2 are sufficient to allow (or require) an entity to disclose relevant information about the sale of output produced before PPE is available for use, if material.

Question 1
Do you agree with the staff recommendation not to include additional disclosure requirements as part of the proposed amendments to IAS 16?

Transition requirements

For entities already reporting under IFRS Standards

16. In considering the need for specific transition requirements, we considered the following factors:

    (a) the amendments to IAS 16, if finalised, would be narrow-scope amendments. Based on discussions of the Interpretations Committee to date, we think that those amendments to IAS 16 are unlikely to affect many entities, because, for most entities, we do not expect the output produced while making PPE available for use to be material. Consequently, some might suggest there is little need for any specific transition requirements—an entity should apply the amendments retrospectively applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

    (b) if an entity is required to apply the amendments retrospectively, it would recalculate the carrying amount of PPE as at the beginning of the earliest comparative period when first applying the amendments. In recalculating the carrying amount of PPE, an entity would be required to go back to when each relevant item of PPE was initially recognised, to ascertain whether proceeds from selling items produced while making the PPE available for use were deducted from the cost of the PPE.

    (c) We expect that entities affected by the amendments, such as entities in the extractives industry, would find it burdensome to apply the amendments retrospectively, especially for items of PPE capitalised some considerable time ago. Consequently, a less burdensome approach would be to require application of the amendments for all items of PPE made available for use on or after the beginning of the earliest comparative period when first applying the amendments. This approach would ensure consistent application of the amendments for all of the periods presented in those financial statements. An entity would, therefore, be required to reassess the carrying amount of only those items of PPE made available for use during the comparative period, or to be made available for use in future periods.

17. Based on the above factors, we think that the benefits of retrospective application are outweighed by the costs. Consequently, we recommend prospective application of the proposed amendments to items of PPE made available for use from the beginning of the earliest comparative period when first applying the amendments.

Question 2
Do you agree with the staff recommendation to require prospective application of the proposed amendments to items of PPE made available for use from the beginning of the earliest comparative period when first applying the amendments?

For first-time adopters

18. In considering the need for an exemption for first-time adopters, we considered the following:

(a) IFRS 1 *First-time Adoption of International Financial Reporting Standards* provides a deemed cost exemption for PPE (paragraphs D5–D7 of IFRS 1). That exemption allows an entity to measure an item of PPE at the date of transition to IFRSs at its fair value, and use that fair value as its deemed cost at that date. Additionally, there are specific deemed cost exemptions for an entity with oil and gas properties in development or production phases (paragraph D8A of IFRS 1), and an entity holding items of PPE that are used, or were previously used, in operations subject to rate regulation (paragraph D8B of IFRS 1).

(b) Apart from the exemptions described above, IFRS 1 does not exempt a first-time adopter from the requirements in IAS 16.

(c) We cannot possibly know of the requirements applied by a first-time adopter in applying its previous GAAP. If a first-time adopter does not apply the deemed cost exemption in IFRS 1, it would apply all of the requirements in IAS 16 retrospectively. Accordingly, we suggest that there is little benefit in providing a first-time adopter with relief from applying this amendment, when it would have to apply all of the other requirements in IAS 16.

19. On the basis of these considerations, we recommend not providing additional transition relief to first-time adopters, beyond the deemed cost exemption already in IFRS 1.

Question 3
Do you agree with the staff recommendation not to provide transition relief for first-time adopters in respect of the proposed amendments to IAS 16?

The wording of the proposed amendments to IAS 16

20. *Appendix B* to this paper sets out our initial thoughts on the wording of the proposed amendments to IAS 16 to reflect the Interpretation Committee's tentative decision.

21. In drafting the proposed amendments, we considered the following:

    (a) the amendments should make clear that an entity can no longer deduct from the cost of PPE proceeds from selling items produced while making the asset available for use.

    (b) the amendments should specify how to account for such proceeds (ie in profit or loss), and also specify how to account for the costs of producing the items sold.

    (c) using the existing words in paragraph 17(e) of IAS 16 to draft the proposed amendments would help to avoid any unintended consequences of narrowing or widening the 'items' to which the existing requirements are applied. We have also drafted the proposed amendments to mirror the style of drafting in paragraph 21 of IAS 16 (refer to Appendix B).

22. The submitter's question related to the words in paragraph 17(e) of IAS 16, and thus the question asked is being addressed by these proposed amendments.

Appendix A
Overview of the previous discussions of the Interpretations Committee

A1. In April 2014, the Interpretations Committee received a request to clarify the requirements in paragraph 17(e) of IAS 16 *Property, Plant and Equipment* to account for net proceeds from selling items produced while testing an item of property, plant and equipment (PPE) under construction. The submitter asked whether an entity recognises the amount by which the net proceeds received exceed the costs of testing in profit or loss or, instead, as a deduction from the cost of the PPE.

A2. The submission raised concerns specifically in relation to the petrochemical industry. The submitter observed that some entities in that sector receive net proceeds from selling items produced while making PPE available for use. Those entities deduct the net proceeds from the cost of the PPE, even when the amount of the net proceeds materially exceeds the costs of testing. The submitter suggested that an entity should deduct net proceeds only from the cost of testing, and that the amount of net proceeds deducted should not exceed the costs of testing.

July 2014 meeting—initial tentative agenda decision

A3. The Interpretations Committee issued a tentative agenda decision in July 2014. That agenda decision indicated that an entity must recognise the amount by which net proceeds received exceed the costs of testing in profit or loss, rather than against the cost of the PPE.

A4. The Interpretations Committee received 10 responses to the tentative agenda decision. The majority of respondents were concerned about the implications of the agenda decision for the extractives industry. One respondent stated that 'the extractive industry approach to accounting for revenue earned before an asset is ready for its intended use (often referred to as pre-commissioning revenue) varies. The various treatments have evolved as a result of the way in which the relatively limited requirements in the Standards have been interpreted and applied. In some instances, the varied treatments have been influenced by alternatives that originated in previous GAAPs. It is not clear how the Committee's tentative agenda decision will impact these treatments, if at all.'

November 2014 meeting—added to the agenda for further consideration

A5. The Interpretations Committee decided to add this item to its agenda to analyse the issue further. The Interpretations Committee said the scope should not be limited to specific industries, and suggested that the staff consider the following issues:

(a) when an item of PPE is available for use;

(b) which costs qualify as costs of testing;

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

(d) how to account for other proceeds received (that do not relate to testing) during the period that an item of PPE is made available for use;

(e) whether to require the disclosure of proceeds deducted from the cost of PPE; and

(f) whether IFRS 15 is applicable to the proceeds received.

January 2015 meeting—further consideration of broader issues

A6. The Interpretations Committee observed that the analysis should focus on the meaning of 'testing' PPE; the reference to proceeds in IAS 16 is made only in relation to testing. On this basis, an entity would assess whether the activity that led to those proceeds was related to testing.

May 2015 meeting—decision to develop a draft Interpretation

A7. The Interpretations Committee tentatively decided to develop a draft Interpretation on the meaning of testing, focusing on the meaning of 'functioning properly' in paragraph 17(e) of IAS 16. The Interpretations Committee considered that functioning properly reflects the technical and physical performance of PPE, and not the financial performance of PPE.

September 2015 meeting—discussion of draft Interpretation

A8. In September 2015, the staff presented the draft Interpretation to the Interpretations Committee. The discussion focused on issues relating to the extractives industry. The Interpretations Committee did not reach consensus and directed the staff to:

(a) develop requirements that clarify the narrowness of the scope of paragraph 17(e) of IAS 16, and the treatment of proceeds from testing in excess of the costs of testing;

(b) develop requirements on the timing of when PPE becomes capable of operating in the manner intended;

(c) consider the relevance of the requirements in paragraph 21 of IAS 16, which refers to income generated by incidental operations;

(d) consider a cost-allocation model for circumstances in which PPE and inventory are produced concurrently before the PPE becomes capable of operating in the manner intended; and

(e) develop a quantitative disclosure requirement for the amount of proceeds that has been deducted from the cost of PPE.

March 2016 meeting—decision to propose narrow-scope amendments [4]

A9. The Interpretations Committee considered whether amendments to IAS 16 could be developed that would clarify some aspects of the accounting for the costs of PPE. The Interpretations Committee considered whether to clarify:

(a) which net proceeds an entity deducts from the costs of PPE;

(b) how an entity interprets ‘testing’; and

(c) when an item of PPE is capable of operating in the manner intended by management.

[4] See Agenda Paper 2 of March 2016 meeting.

A10. The Interpretations Committee concluded that developing a solution to resolve these broader questions would be considerably more complex than developing a solution for the question raised in the submission. Consequently, the Interpretations Committee discussed:

(a) restricting the amount of proceeds that an entity deducts from the cost of PPE to only those proceeds arising from testing activities, and clarify that the net proceeds deducted should not exceed the costs of testing included as part of the cost of PPE; and

(b) prohibiting the deduction of proceeds from the cost of PPE.

A11. The Interpretations Committee tentatively decided to propose a narrow-scope amendment to IAS 16 to prohibit the deduction from the cost of PPE proceeds from selling items produced before the item of PPE is capable of operating as intended by management (paragraph A10(b) above).

A12. The Interpretations Committee also decided not to develop a cost-allocation model for circumstances in which PPE and inventory are produced concurrently before the PPE is capable of operating in the manner intended. The staff noted that IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* includes requirements for the allocation of costs when PPE and inventory are produced at the same time. That Interpretation has a narrow scope—it provides requirements only for stripping costs in the production phase of a surface mine. The requirements in IFRIC 20 are based on the cost allocation principles for joint products in IAS 2.

Appendix B
Initial staff thoughts on the wording of the proposed amendments to IAS 16

Elements of cost

…

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

(f) …

…

20A Some items are produced while bringing an asset to the location and condition necessary for it to be capable of operating in the manner intended by management (such as samples produced when testing equipment). An entity recognises the proceeds from selling such items and the cost of producing those items in profit or loss in accordance with other applicable Standards.

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.

…