STAFF PAPER

IFRS Interpretations Committee Meeting

Project	**Property, Plant and Equipment: Proceeds before Intended Use**
Paper topic	Analysis of feedback on the proposed amendments to IAS 16

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This paper will be discussed at the IFRS Interpretations Committee meeting in June 2018.

Introduction and purpose

1. In June 2017, the International Accounting Standards Board (Board) published the Exposure Draft *Property, Plant and Equipment —Proceeds before Intended Use* (ED). The comment period ended in October 2017. We provided the Board with a summary of the feedback in December 2017, and advised the Board that we would provide an analysis of the feedback to the IFRS Interpretations Committee (Committee) at a future meeting in order to obtain the Committee's advice on the project.

2. Many respondents to the ED either disagreed with, or expressed concerns about, the proposed amendments. In the light of the feedback received, we performed follow-up research with a number of respondents in order to:

   (a) clarify some of the matters raised in comment letters; and

   (b) obtain a better understanding of some of the practical challenges identified.

3. Following the Committee's discussion of this paper in June 2018, we will present the Committee's advice to the Board at a future meeting, together with advice from the Accounting Standards Advisory Forum (ASAF). We plan to discuss the project with ASAF in July 2018.

4. The objective of this paper is to:
    (a) provide the Committee with an analysis of the feedback on the ED, considering both comment letters and information obtained from our follow-up research; and
    (b) explore possible ways to move forward on this project.

Structure of the paper

4. This paper is structured as follows:
    (a) background;
    (b) feedback;
    (c) staff analysis; and
    (d) possible ways to move forward.

5. […]

Background

7. Paragraph 16(b) of IAS 16 *Property, Plant and Equipment* states that the cost of an item of property, plant and equipment (PPE) includes costs directly attributable to bringing that asset to the location and condition necessary for it to be capable of operating in the manner intended by management[1]. Paragraph 17 of IAS 16 specifies examples of directly attributable costs. Paragraph 17(e) identifies as one such example the cost of testing whether the asset is functioning properly, after deducting

[1] For ease of reference, this paper uses the phrases 'available for use' or 'intended use' to describe the point in time at which an item of PPE is in the location and condition necessary for it to be capable of operating in the manner intended by management.

the net proceeds from selling any items produced while making the asset available for use.

8. The Board developed the proposed amendments in response to a request to the Committee asking whether:
   (a) the proceeds specified in paragraph 17(e) of IAS 16 relate only to items produced from testing; and
   (b) an entity deducts from the cost of an item of PPE any proceeds that exceed the costs of testing.
9. The Committee's work on the request indicated that entities apply diverse reporting methods in the treatment of sales proceeds before an asset is available for use, particularly in capital-intensive industries such as the extractive and petrochemical industries.
10. The proposed amendments to IAS 16 would prohibit deducting from the cost of an item of PPE any proceeds from selling items produced before the asset is available for use. Consequently, an entity would recognise such sales proceeds, together with the cost of producing those items, in profit or loss applying the applicable Standards.
11. The proposed amendments would also clarify the meaning of 'testing' in paragraph 17(e) of IAS 16—ie when testing whether an item of PPE is functioning properly, an entity assesses the technical and physical performance of the asset, and not its financial performance.
12. The Board proposed that entities apply the amendments retrospectively to items of PPE made available for use on or after the beginning of the earliest period presented when an entity first applies the amendments.

Feedback received

14. We received seventy-one comment letters that can be accessed here.
15. We also received feedback from ASAF and GPF members in July and October 2017 respectively, summarised in Appendices B and C to this paper.

16. In order to obtain a better understanding of some of the matters raised in the comment letters, we conducted outreach with a number of stakeholders. We held discussions with:

    (a) regulators,

    (b) audit firms,

    (c) standard-setters,

    (d) preparers (including mining companies), and

    (e) an investor who follows the extractive industry.

17. We also considered feedback from past outreach activities when the Committee undertook research on this project, including feedback summarised in Agenda Paper 3C of the January 2015 Committee meeting. This paper can be accessed here.

Staff analysis

Recognition of the proceeds and related costs in profit or loss

Board's view

19. The Board's view is that requiring an entity to recognise all sales proceeds, and any related costs, in profit or loss would result in the following improvements in financial reporting:

    (a) the current diversity in when, and the extent to which, entities deduct sales proceeds from the cost of an asset would be removed;

    (b) users of financial statements would have a clearer picture of the total cost of an item of PPE (and thus of the consumption of this asset in future reporting periods); and

    (c) users of financial statements would have a clearer picture of an entity's total revenue (or income) for each period.

Main comments received

20. Some respondents (including some preparers, regulators and the investor with whom we met) supported reporting the proceeds as revenue (or income) in profit or loss. They said this would improve financial reporting, in particular by removing diversity in reporting practices. For example, one respondent said:

> CPA Australia supports the proposed amendments to prohibit deducting any sales proceeds from the cost of developing an item of property, plant and equipment. It is our view that the proposed amendments are likely to reduce the current diversity in practice when applying the relevant provisions of IAS 16 […]. [CPA Australia Ltd]

Another respondent said:

> Most members agree with the Board's proposal because they believe that the amendments to prohibit deducting proceeds from selling items produced from the cost of an item of property, plant and equipment […] will reduce diversity and result in improved financial reporting. [IOSCO]

21. In contrast, some respondents questioned whether the proposed amendments would provide relevant information. In particular, those respondents said the proposed amendments might result in:

(a) entities recognising in profit or loss income and expenses from the sale of items before an item of PPE is available for use, that may not be representative of sales (and related costs) after the item of PPE is available for use. In particular, this is because the cost of items sold before the item of PPE is available for use excludes depreciation of that asset. Accordingly, the information derived from the statement of profit or loss with respect to the sale of these items may not have predictive value.

(b) additional volatility in profit or loss and in some key ratios—such as earnings per share. This was a particular concern for the mining companies with whom we met—they said it might encourage entities to use non-GAAP measures.

22. The investor with whom we met said the proposed amendments would result in improved financial information. This investor however mentioned the additional

volatility in profit or loss that might result. In this investor's view, without sufficient knowledge of the amendments, investors may not fully appreciate and understand the reasons for any changes in key metrics of mining companies.

23. Those who expressed concerns about the relevance of the information provided by the proposed amendments suggested that the Board not change the existing measurement requirements in IAS 16 and, instead, require specific disclosure—in particular disclosures about the amount of proceeds credited against the cost of PPE. The entities with whom we discussed this said that such information would not be difficult to provide. The investor said the disclosure of such information would be useful.

Staff analysis

The Framework

24. In March 2018, the Board issued the revised *Conceptual Framework for Financial Reporting* (Framework). Paragraph 4.68 of the Framework includes the following definition:

> Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

25. In our view, the proceeds from selling items produced before an item of PPE is available for use meet the definition of income in the Framework. This income reflects an entity's performance. Therefore, an entity would recognise such income in profit or loss, unless the Board requires otherwise.

26. Accordingly, we think the proposed amendments are consistent with the concepts included in the Framework and, thus, provide useful information, ie information that is relevant and faithfully represent what it purports to represent.

The relevance of financial information

27. We understand that the proceeds earned before an item of PPE is available for use may have little predictive value in relation to the future cash flows that an entity will derive from an asset once the asset is available for use. We would expect the quantities, and often the nature, of items sold before an item of PPE is available for use to be very different from those sold after the asset is available for use. However,

we think the recognition of income and related expenses in profit or loss reflects an entity's performance and has confirmatory value.

28. Based on the feedback received, we think the Board may reconsider whether specific presentation or disclosure requirements are necessary to enable users of financial statements to identify such proceeds and their related costs.

29. We think that presentation or disclosure requirements would be particularly important for 'junior' mining entities—ie entities operating few extractive projects. The proposed amendments for such entities could materially affect their financial statements. This is because:

    (a) applying the existing requirements in IAS 16, we understand that those entities generally do not report any significant amounts of revenue (or income) before the commercial phase of a mine begins—ie those entities generally credit sales proceeds earned during the development phase of a mine against the cost of the mine.

    (b) applying the proposed amendments, those entities would recognise in profit or loss the proceeds and costs from selling items before the commercial phase begins and, thus, might report profitable results during that development phase. Such entities might ultimately be unable to achieve a significant level of production from the particular extractive projects. Accordingly, without additional information, an investor may not reasonably be able to use this information to assess the entity's future performance.

Cost allocation

Board's view

30. In recognising sales proceeds in profit or loss, the Board observed in paragraph BC7(a) of the ED that an entity would be required to identify costs that relate to items produced and sold before an item of PPE is available for use. The proposed amendments would therefore require any such costs to be distinguished from other costs incurred before an item of PPE is available for use—in particular, costs directly attributable to making an item of PPE available for use, which the entity includes in

the cost of the asset[2]. In paragraph BC8 of the ED, the Board observed that the proposed amendments would require little more judgement beyond that already required to apply IFRS Standards—in particular the requirements in IAS 16, IAS 2 *Inventories* and IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine*.

Main comments received

31. Many respondents disagreed with the Board's observations above. We identified three broad categories of interrelated concerns.

Practical challenges

32. Some respondents said it is practically difficult to identify costs that relate to items produced and sold before an item of PPE is available for use, and distinguish them from other costs.

33. In particular, some mentioned significant challenges for entities operating in the extractive industry. This is mainly because of:

    (a) the nature and magnitude of operations in that industry. For example, one respondent indicated that an extractive entity might have as many as 5,000 cost inputs to produce inventory, most of them being indirect costs.

    (b) the life cycle of a mine goes through various stages from prospecting to reclamation. A number of activities may be undertaken in constructing a mine (for example, removal of overburden, trial mining, commissioning and ramp-up). Depending on the size of the mine, different geographical areas of the mine may be at different stages of development or production. This means the allocation of costs between sales proceeds and the cost of PPE may vary in different parts of the mine.

Use of judgement

34. Some respondents said the proposed amendments might require extensive use of judgement—in particular, to allocate indirect costs in circumstances in which an entity would not have reliable data on the 'normal capacity' of an item of PPE.

[2] This paper refers to the identification of costs that relate to items produced before an item of PPE is available for use as 'cost allocation'.

Diversity in the reporting of costs

35. Some respondents mentioned the potential diversity in the reporting of costs that might result from the proposed amendments. This is because the proposed amendments do not include any principle or application guidance in relation to cost allocation. They said a variety of different approaches may evolve, each resulting in a different reflection of financial performance—in particular, for the extractive industry.

36. Many respondents said the Board should, as a minimum, set out a cost allocation principle or suggested the Board should provide application guidance or examples. A few of those respondents identified methods of cost allocation that may assist entities in applying the proposed amendments. Those approaches consisted in allocating to items produced before an item of PPE is available for use:

    (a) a cost equal to the proceeds earned,

    (b) no cost at all,

    (c) an incremental cost, or

    (d) a standard or expected cost (excluding depreciation).

37. Those respondents also suggested that the Board consider incorporating into IAS 16 some of the paragraphs included in the Basis for Conclusions (in particular, paragraph BC9[3]), which they view as helpful.

Staff analysis

Practical challenges

38. In our view, the concerns that many respondents raised about cost allocation relate to the broader issue of the allocation of 'joint costs', ie the costs of a production process

[3] Paragraph BC9 of the ED states: 'in applying the proposed amendments, an entity might need to assess whether particular costs incurred are costs of inventories (applying IAS 2), costs of testing (applying IAS 16) or costs the entity would be required to recognise in profit or loss. The Board noted that the existing requirements in IAS 2 and IAS 16 on costs are helpful in this respect. For example, in assessing whether costs incurred while an item of PPE is being tested are costs of inventories or costs of testing (included in the cost of the item of PPE), an entity would consider whether the items produced during testing meet the definition of inventories in IAS 2. Similarly, an entity might consider whether particular costs represent (a) abnormal amounts of wasted material (recognised in profit or loss); or (b) costs necessary to make the item of PPE available for use or to bring inventories to their present location and condition.'

yielding different types of output at the same time. In particular, joint costs arise when:

(a) a process produces joint products or by-products[4]. We understand that joint products and by-products are quite common for many entities—including those operating in the extractive industry. Paragraph 14 of IAS 2 specifies cost allocation requirements for such items.

(b) sales proceeds arising from incidental operations—ie operations that occur in connection with the construction or development of an item of PPE but that are not necessary to make the asset available for use. Paragraph 21 of IAS 16 requires such proceeds (and their related expenses) to be recognised in profit or loss.

39. In the light of the circumstances identified above, we think the proposed amendments do not create new practical challenges from a cost accounting perspective. We note that, in those circumstances, entities have already applied judgement in determining a cost allocation methodology that is rational and consistent. Stakeholders have not reported specific application difficulties in those circumstances. Accordingly, we think entities could consider their experience in allocating joint costs in applying the proposed amendments.

40. In addition, the comment letters and our additional research confirmed that the proposed amendments are unlikely to affect most industries because sales proceeds before intended use are typically not material for entities in those industries.

41. In addition, a number of entities affected by the proposed amendments said:

(a) they have cost allocation systems such as ERPs (Entreprise Resources Planning systems) in place that are capable of implementing the changes arising from the proposed amendments; and

(b) they could make the necessary judgements, using their experience on cost allocation.

[4] In practice, we understand that joint products are products that have more than an insignificant selling price while by-products have an insignificant selling price (in this case, it is common to refer to the main product and the related by-product).

42. Nonetheless, we acknowledge the existence of practical challenges for the extractive industry. In particular, this is because:

    (a) the complexity of operations in this industry makes the scale of cost allocation bigger than for other industries.

    (b) operationalising the proposed amendments might result in additional implementation costs. As noted in one comment letter and during outreach, the proposed amendments would require an analysis of direct and indirect costs incurred before an item of PPE is available for use—thereby requiring the tracking of some costs at more granular level. For example, an entity might need to apportion the costs of development teams testing an item of PPE between the cost of items sold and the cost to be capitalised as part of the asset. This would require tracking of hours spent by those teams. At present, entities do not need to monitor those hours, except for abnormal costs.

43. Having said that, we think that any entity that has material amounts of sales proceeds before an item of PPE is available for use would often construct or develop large items of PPE. This would occur in the context of complex and lengthy projects, which involve many inputs and cost drivers. For such entities, the management of costs is typically an essential part of managing those construction or development projects. Accordingly, we think that the cost allocation required by the proposed amendments would be feasible for those entities.

Use of judgement

44. We acknowledge that the proposed amendments would require entities to apply judgement to a new area of cost allocation. In particular, we understand that allocating costs when an item of PPE is being constructed—ie when production is not yet stable—may not be as straightforward as when such an asset is available for use.

45. However we think the judgement involved is not substantially different from judgements already required in applying other IFRS Standards—for example, applying IAS 2 in allocating production overheads to compute the costs of conversion of inventory.

Diversity in the reporting of costs

46. We acknowledge respondents' concerns and see benefit in the Board considering the inclusion of a principle and/or requirements on cost allocation. We discuss the possible actions the Board might undertake in relation to cost allocation in paragraphs 95-98 of this paper.

47. Some respondents expressed particular concerns that the potential diversity in cost allocation methodologies might result in the potential loss of comparability among entities operating in this industry.

48. Nonetheless, we note that:

    (a) many entities operating in the extractive industry apply the requirements in IFRS 6 *Exploration for and Evaluation of Mineral Resources,* which permits various accounting practices in relation to many aspects of the recognition, measurement and presentation of exploration and evaluation assets. Those assets often represent material balances in the statement of financial position of entities operating in the extractive industry.

    (b) the investor with whom we met has observed diversity in reporting practices in relation to the accounting of costs incurred during the development phase of a mine.

    (c) some mining entities said that sales proceeds are often not material at a group level, although they are likely to be material for some segments.

Available for use

Board's view

49. As explained in paragraphs BC18-22 of the ED, the Board considered clarifying when an item of PPE is available for use as a possible approach to reduce the identified diversity in the reporting of sales proceeds. In particular, paragraph BC20[5] of the ED

[5] Paragraph BC20 of the ED states: '[…] The Board considered whether to amend IAS 16 to include the following as indicators of when an item of PPE is available for use:

(a) the physical construction of the asset is complete (as described in paragraph 23 of IAS 23 *Borrowing Costs*).

(b) the testing of the technical and physical performance of the asset is complete […].

includes the indicators of when an item of PPE is available for use that the Board considered including in IAS 16.

50. In its deliberations, the Board concluded that such an approach:

    (a) would be a much broader project than the proposed amendments would be; and

    (b) would not have removed the existing need to apply judgement in determining when an item of PPE is available for use.

Main comments received

51. Many respondents said that clarifying the requirements on when an item of PPE is available for use is fundamental to resolving the issue the Board is trying to address through the proposed amendments. Some of those respondents said entities interpret differently when an item of PPE is available for use.

52. However, almost none of those respondents provided suggestions on how to clarify the existing requirements in IAS 16. In particular, respondents did not comment on the indicators of available for use set out in paragraph BC20 of the ED.

Staff analysis

What is creating differing interpretations of available for use?

53. During our outreach, several respondents indicated that entities interpret differently the phrase in paragraph 20 of IAS 16 'to be in the location and condition necessary for [an item of PPE] to be capable of operating in the manner intended by management'. More precisely, some said:

    (a) 'to be in the location and condition necessary for [an item of PPE] to be capable of operating' implies a technical and physical assessment of the item of PPE; however

    (b) 'in the manner intended by management' may imply that an entity could also assess the financial performance of the item of PPE.

(c) the asset is capable of producing items that can be sold in the ordinary course of business (ie capable of producing inventories as defined in IAS 2). Consistent with the meaning of testing, this assessment would focus on the technical and physical performance of the asset, and not its financial performance.

54. Some other respondents said that distinguishing a physical assessment of an asset and an assessment of its financial performance is difficult in some circumstances. For example, an entity may consider that an item of PPE is available for use when it is capable of producing a specified percentage of its 'normal' capacity over a specified period of time. This percentage can be set in such a way that, when the percentage is achieved, the asset is operating at more than break-even. In this case, some said it is unclear whether such an assessment is technical or financial.

55. A few respondents supported the Board's proposed definition of testing activities, set out in paragraph 17(e) of the proposed amendments and explained further in paragraph BC10 of the ED. This definition states that testing activities relate only to the technical and physical performance of an item of PPE. However, those respondents were not convinced this definition would effectively remove uncertainties about the date on which an item of PPE is available for use.

56. The investor with whom we met said little information is typically available on the assessment that mining companies make of when a mine is available for use. The investor said improving disclosure about this judgement—which is often material for mining companies—would be helpful.

Requirements included in US GAAP

57. During outreach, a few respondents suggested that the Board consider the notion of 'intended use' in US GAAP requirements, which in their view enable preparers to apply their judgement in a more consistent manner[6]. This definition puts emphasis on the physical assessment of the asset. In those respondents' view, this definition results in US GAAP entities generally having no material proceeds from the sale of items produced before an item of PPE is ready for its 'intended use'—and hence there is no cost allocation to perform.

58. Those respondents noted specific industry guidance for extractive entities, which clarifies when depreciation of a mine starts—ie when the production phase starts. In

[6] Topic 835—*Interest* refers to 'intended use' which is defined as follows: 'intended use of an asset embraces both readiness for use and readiness for sale, depending on the purpose of acquisition'.

particular, Topic 930 *Extractive Activities – Mining* defines the 'production phase' as follows:

> The production phase of a mine is deemed to begin when saleable minerals are extracted (produced) from an ore body, regardless of the level of production. However the production phase does not commence with the removal of de minimis saleable mineral material that occurs in conjunction with the removal of overburden or waste material for the purpose of obtaining access to an ore body.

Staff view

59. In our view, the indicators of when an asset is available for use included in paragraph BC20 of the ED could potentially address some (but not all) stakeholders' concerns. We also note they would align the requirements in IAS 16 on available for use with those in IAS 23 on when capitalisation of interest ceases.

60. In addition, based on the feedback received, we think those indicators would result in 'available for use' in IAS 16 being described similarly to 'intended use' in US GAAP.

61. However, as explained in paragraph 52 above, respondents did not comment on those indicators, so it is unclear whether they assessed those indicators as useful.

62. Were the Board to reconsider the approach of clarifying when an asset is available for use, we think we would need to gather further evidence of the significance of the matter and obtain further feedback on the possible standard setting solutions. We note that, at present, we do not have such evidence, other than the comments received in comment letters on this ED. We also note that respondents to the *2015 Agenda Consultation* did not specifically refer to it as a suggestion for possible additional projects to be added to the Board's work plan.

Exclusion of depreciation

Board's view

63. The Board observed in paragraph BC11 of the ED that before an item of PPE is available for use, the costs of producing items sold excludes depreciation of that asset. This is because depreciation of an asset begins when it is available for use. In the

Board's view, any consumption of an item of PPE before it is available for use is likely to be negligible.

Main comments received

64. Many respondents expressed concerns about excluding depreciation from the cost of items produced before an item of PPE is available for use. In particular, they disagreed with the Board's observation in paragraph BC7 of the ED that the cost of items produced before an item of PPE is available for use excludes the depreciation of that asset.

Staff analysis

65. Paragraph 55 of IAS 16 states:

> 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.

66. Accordingly, the Board's observation in BC11 of the ED reflects the requirements in IAS 16.

67. IAS 16 assumes that the consumption of the expected future economic benefits embodied in an item of PPE starts when the asset is available for use. In our view, if an entity were to assess that the consumption of an item of PPE is more than negligible during its construction or development, then this would indicate that the asset is already available for use (ie already in the location and condition necessary for it to be capable of operating in the manner intended by management). Accordingly, we agree with the Board's observation that any consumption of an item of PPE before it is available for use is likely to be negligible.

Assessment of 'ordinary' activities

Board's view

68. The Board observed in paragraph BC24 of the ED that if the item of PPE under construction is to be used in the entity's ordinary activities, there is no basis on which to conclude that inventories produced by the asset before it is available for use would not be output from the entity's ordinary activities.

Main comments received

69. Many respondents disagreed with the Board’s assessment that sales proceeds before an item of PPE is available for use would typically arise from an entity's ordinary activities. For some respondents, if those items are not part of an entity’s ordinary activities, that would support retaining the existing requirements in IAS 16 of crediting the sales proceeds against the cost of an item of PPE.

Staff analysis

70. We note that the Board’s observation to which some respondents referred is included in the Basis for Conclusion of the ED. Accordingly, the Board intended neither to override management’s assessment of ordinary activities nor specify requirements in this respect. The Board’s observation in paragraph BC24 of the ED was included as an explanation of the Board’s decisions regarding disclosure requirements.

71. We also note that paragraph 20A of the proposed amendments requires the proceeds and related costs be recognised in profit or loss ‘in accordance with applicable Standards’.

72. If an entity were to assess that the proceeds relate to items that are *not* output of its ordinary activities, those proceeds and their related production costs would not be within the scope of IFRS 15 (ie the proceeds would not meet the definition of revenue) or IAS 2 respectively. However, they would still meet the definitions of income and expense as defined in paragraphs 4.68 and 4.69 of the Framework. Accordingly, we think an entity should recognise them in profit or loss, regardless of whether they arise from an entity’s ordinary activities.

73. We think the Board may need to consider further the possible implications on presentation and disclosure of an entity assessing that sales proceeds before an item of PPE is available for use are not part of its ordinary activities. In those circumstances, the disclosure requirements in IFRS 15 and IAS 2 might not apply to the proceeds and related production costs. As explained in paragraphs 28-29 above, disclosure of the amount and treatment of sales proceeds before an item of PPE is available for use may be important for users of financial statements.

Interaction with other Standards

IAS 23 Borrowing costs

Main comments received

74. Some respondents supported the alternative view expressed in paragraph AV6 of the ED stating that the proposed amendments would be inconsistent with IAS 23.

75. In particular, those respondents supported retaining the existing requirements in paragraph 17(e) of IAS 16 on the basis that crediting against the cost of an item of PPE sales proceeds before this item of PPE is available for use is, in their view, consistent with the requirements in paragraph 12 of IAS 23.

Staff analysis

76. Paragraph 12 of IAS 23 paragraph states (emphasis added):

> To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as **the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowing**s.

77. Paragraph 13 of IAS 23 goes on to state (emphasis added):

> The financing arrangements for a qualifying asset may result in **an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset**. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, **any investment income earned on such funds is deducted from the borrowing costs incurred**.

78. The requirements in paragraphs 12-13 of IAS 23 apply when an entity borrows funds and does not use them immediately for the acquisition, construction and production of a qualifying asset. The entity might temporarily invest those funds, earning interest income, before using them to obtain a qualifying asset.

79. In our view, those requirements are a way of preventing the capitalisation of borrowing costs that do not relate to the qualifying asset—those requirements ensure that an entity capitalises only borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. Accordingly, in our view the requirements in IAS 23 do not conflict with the proposed amendments.

Requirements in IAS 16 and IAS 2 on 'abnormal' costs

Main comments received

80. The Board noted in paragraph BC8 of the ED that an entity is required by IAS 2 and IAS 16 to recognise particular abnormal costs as expenses in the period in which they are incurred—these include abnormal amounts of wasted materials, labour or other costs of producing inventory or self-constructing an item of PPE. Some respondents suggested that an entity should capitalise such costs related to self-constructing an item of PPE because they are necessary to make the asset available for use. A few respondents also asked for clarification of the nature of abnormal costs.

Staff analysis

81. In paragraph BC8 of the ED, the Board outlined the existing requirements in IAS 2 and IAS 16 in explaining its decision regarding cost allocation. We think it is beyond the scope of the project to reconsider those requirements on abnormal costs.

Interaction with the requirements in IFRS 6

Main comments received

82. A few respondents asked the Board to clarify whether the proposed amendments would also apply to assets within the scope of IFRS 6 *Exploration for and Evaluation of Mineral Resources*.

Staff analysis

83. We understand that, in applying IFRS 6, some entities have credited sales proceeds against the cost of exploration and evaluation assets. If the Board proceeds with the proposed amendments, then we think it should also propose a similar amendment to IFRS 6, including the transition requirements.

Possible ways to move forward

85. The second objective of this paper is to ask for the Committee's advice on the possible ways to move forward with the project.

86. Ultimately, as set out in paragraph 1.2 of the Framework, the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors relating to providing resources to the entity. However, as stated in paragraph 2.39 of the Framework, there is a cost constraint on useful financial reporting and it is important that the costs imposed by reporting financial information be justified by the benefits of reporting that information.

87. The primary matters for consideration that we have identified in relation to this project relate to:
    (a) the recognition of sales proceeds as revenue (or income) in profit or loss;
    (b) the potential diversity that may result relating to cost allocation;
    (c) the point in time at which an asset is considered to be available for use;
    (d) the significance of the issue for different industries and whether industry specific guidance is required; and
    (e) balancing the importance of disclosing clear and transparent information in this area with concerns relating to disclosure overload.

88. To facilitate the discussion at this meeting, we have set out possible approaches for consideration.

Approach 1: Proceed with the ED as published

Approach

89. Applying Approach 1, the Board would proceed with the amendments as proposed in the ED, largely without modification.

Advantages

90. An entity would recognise sales proceeds as revenue (or income) in profit or loss, consistent with the definition of income in the Framework. This would improve the information about revenue (or income) provided to users of financial statements.

91. The approach would address the diversity identified in the reporting of sale proceeds before an item of PPE is available for use.

92. The approach would result in change only for those entities with material amounts of sales proceeds before items of PPE are available for use—ie those entities for which diversity in reporting has been identified. The many entities that do not have material amounts of such sales proceeds would be unaffected by the amendments.

Disadvantages

93. The approach would not address one of the main concerns raised by stakeholders—ie how to determine the costs of producing items sold before an item of PPE is available for use that an entity would recognise in profit or loss. Consequently, there is a risk that in reducing the diversity in the reporting of sale proceeds, the amendments could create new diversity in the costs recognised in profit or loss. Such an outcome would reduce the benefits of the amendments.

94. The approach would not require any specific disclosure of information about the sale of item produced before an item of PPE is available for use. Such information may be necessary so that users of financial statements can understand the effect of such sales on the entity’s financial performance.

Approach 2: Proceed with the ED with some modifications

Approach

95. Applying Approach 2, the Board would proceed with the amendments as proposed in the ED, but incorporate changes to address some of the main concerns raised in the feedback. Those changes could include some or all of the following:

    (a) a principle regarding the identification of the costs of producing items sold. That principle could be similar to the principle in IAS 2 regarding joint products (ie allocate on a rational and consistent basis). The Board could also develop additional requirements or examples on the identification and allocation of costs, for example:

(i) by incorporating into IAS 16 the Board's observations in paragraph BC9 of the ED about the application of the requirements in IAS 2 and IAS 16;

(ii) by requiring the recognition in profit or loss of only particular costs of producing items sold (for example, only direct costs of producing those items); or

(iii) by including examples of ways in which an entity might allocate costs on a rational and consistent basis.

(b) expand the definition of 'testing' included in the proposals. This could be done by incorporating within IAS 16 some of the explanatory text in paragraph BC10 of the ED.

(c) incorporate specific disclosure requirements relating to the sale of items produced before an item of PPE is available for use. Such disclosure requirements could include (if material and not already captured by another Standard):

(i) the amount of sales proceeds recognised in profit or loss for the period;

(ii) a description of the nature of the items sold as described in (i) and, if necessary, the extent to which the products sold differ from items produced and sold after an asset is available for use; and

(iii) the amount of costs allocated to profit and loss in respect of the sales proceeds described in (i) and the methodology used to determine such costs.

Advantages

96. In addition to the advantages identified for Approach 1, this approach could address many of the concerns raised about cost allocation, and reduce the risk of creating diversity in the recognition of costs in profit or loss.

97. The approach would also provide information to help users of financial statements understand the effects on an entity's financial performance of sales of items produced before PPE is available for use.

Disadvantages

98. If the Board were to include requirements on the identification of costs, we think that further analysis and testing of those requirements may be required. There are likely to be differing views on how prescriptive any cost identification and allocation requirements should be. This would add to the timeline and complexity of the project.

Approach 3: Proceed with additional disclosure requirements and consider alternative standard-setting approaches

Approach

99. Applying Approach 3, the Board would not proceed with the amendments to the measurement requirements in IAS 16 as proposed, but instead add disclosure requirements to IAS 16. Those disclosure requirements could include:

(a) the amount of sale proceeds credited against the cost of PPE in the period; and

(b) a description of how an entity has determined the date at which PPE is available for use (if the amount of sale proceeds credited against the cost of PPE is material to the entity).

100. As a second step, the Board could then consider one of the following:

(a) exploring whether it might propose to amend IAS 16 to clarify the date at which PPE is available for use—for example, by considering the indicators specified in paragraph BC20 of the ED; or

(b) considering the issue of sales proceeds before intended use as part of its research project on *Extractive Activities*.

Advantages

101. Although not directly addressing the diversity identified in the reporting of sales proceeds, this approach would provide users of financial statements with insights into

an entity's approach to the capitalisation of costs associated with the construction or development of items of PPE for some capital-intensive industries.

102. Many stakeholders suggested that the cause of the issue the Board is aiming to address in this project is differing interpretations of the date on which an item of PPE is available for use. Amending IAS 16 to clarify that date would potentially address the issue more comprehensively than the proposed amendments in the ED. The indicators of that date described in paragraph BC20 would appear to result in 'available for use' in IAS 16 being described similarly to 'intended used' be in US GAAP. We understand that 'intended use' in US GAAP works well in practice.

103. Alternatively, feedback would suggest that the issue identified arises mainly in the extractive industry because of the capital-intensive nature of the operations and, thus, the time that it takes to construct or develop items of the PPE for that industry. Consequently, the issue might be best addressed within the Board's project on *Extractive Activities*.

Disadvantages

104. If the Board were to explore clarifying the date on which an item of PPE is available for use, this approach would expand the scope of the project and the timeframe involved in its completion. Although discussed in the Basis for Conclusions on the ED, any proposals on the date on which an item of PPE is available for use may require exposure. In addition, it is not clear that such an approach would result in a better solution than Approach 2, which ties more closely to the proposed amendments in the ED.

105. If the Board were to consider the issue as part of its project on *Extractive Activities*, it would not address for some time the diversity identified in the reporting of sale proceeds before an item of PPE is available for use.

Questions for the Committee

106. The feedback in comment letters and follow up research have confirmed the existence of the financial reporting issue that the Board is aiming to address in this project—ie

the feedback confirms that diversity exists in the reporting of sales proceeds before an item of PPE is available for use for particular industries.

107. In our view, that feedback also suggests that the benefits of proceeding with the ED as published (Approach 1) might not outweigh the costs. In particular, we note the risk that in reducing the diversity in the reporting of sale proceeds, the proposed amendments could create new diversity in the costs recognised in profit or loss.

108. We are interested in the Committee's advice on how best to proceed on this project.

Questions 1 and 2 for the Committee
Question 1—Do Committee members have any questions or comments on the analysis set out in paragraphs 19-83 of this paper? **Question 2**—What advice do Committee members have for the Board on how to proceed on this project? In particular, would you suggest proceeding with any of the approaches outlined in this paper, or would you suggest an alternative approach? Please explain your views.