STAFF PAPER

June 2019

IASB Meeting

Project	**Property, Plant and Equipment: Proceeds before Intended Use (Amendments to IAS 16)**
Paper topic	Finalisation of the proposed amendments

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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* (Exposure Draft). The Exposure Draft proposes to amend IAS 16 *Property, Plant and Equipment* to prohibit deducting from the cost of an item of property, plant and equipment (PPE) any proceeds from selling items produced while bringing that asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Instead, an entity would recognise sales proceeds in profit or loss.

2. In November 2018, the Board considered feedback on the Exposure Draft[1] and decided to proceed with finalising the amendments with some modifications. This paper analyses those modifications and asks the Board whether it agrees with our recommendations.

3. If the Board agrees with those recommendations, we will bring to a future Board meeting a paper (a) discussing the due process steps; and (b) asking the Board for permission to begin the balloting process on the final amendments to IAS 16.

[1] Agenda Paper 12B of the November 2018 Board meeting includes our analysis of feedback.

Structure of the paper

4. This paper is structured as follows:

   (a) summary of the proposed amendments (paragraphs 6–9);

   (b) summary of staff recommendations (paragraph 10);

   (c) background (paragraphs 11–13); and

   (d) staff analysis and recommendations (paragraphs 14–54).

5. This paper includes one Appendix: Extracts from the Basis for Conclusions on the Exposure Draft.

Summary of the proposed amendments

6. Paragraph 16(b) of IAS 16 states that the cost of an item of 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[2]. Paragraph 17 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 the net proceeds from selling any items produced while making the asset available for use.

7. The proposed amendments to IAS 16 would:

   (a) prohibit deducting from the cost of an item of PPE any proceeds from selling items produced before the asset is available for use (sales proceeds). Consequently, an entity would recognise such proceeds, together with the costs of producing those items (production costs), in profit or loss applying IFRS Standards.

   (b) clarify the meaning of 'testing' in paragraph 17(e)—ie when testing whether an item of PPE is functioning properly, an entity assesses the

[2] 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.

technical and physical performance of the asset, and not its financial performance.

8. The Board proposed no additional disclosure requirements. Paragraphs BC24–BC26 of the proposed amendments (reproduced in the Appendix to this paper) explained that the Board expects items produced before an item of PPE is available for use to be output from an entity's ordinary activities. Accordingly, sales proceeds and production costs would meet the definition of revenue and inventory respectively. Consequently, the Board concluded that the requirements in IFRS 15 *Revenue from Contracts with Customers* and IAS 2 *Inventories* would be sufficient to require an entity to disclose relevant information about the sale of output produced before an item of PPE is available for use.

9. 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.

Summary of staff recommendations

10. We recommend that the Board:

    (a) amend IAS 16 to require an entity to identify and measure the cost of items produced before an item of PPE is available for use applying the measurement requirements in paragraphs 9–33 of IAS 2.

    (b) not develop presentation or disclosure requirements for the sale of items that are part of an entity's ordinary activities. However, for the sale of items that are not part of an entity's ordinary activities (and to which the entity does not apply IFRS 15 and IAS 2), we recommend that the Board amend IAS 16 to require the entity to:

        (i) disclose separately the amount of (a) sales proceeds and (b) related production costs recognised in profit or loss; and

        (ii) specify the line item(s) in the statement of profit or loss that include(s) the sales proceeds and production costs.

(c) not make any consequential amendments to IFRS 6 *Exploration for and Evaluation of Mineral Resources* and IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine*.

Background

11. In November 2018, the Board considered feedback on the Exposure Draft, and advice from the IFRS Interpretations Committee (Committee) and the Accounting Standards Advisory Forum, on next steps for the project. At that meeting, the Board tentatively decided to proceed with the proposed amendments with some modifications that might include:

    (a) clarifying how an entity would identify production costs; and

    (b) presentation and disclosure requirements.

12. Paragraphs 14–44 of this paper discuss these modifications. Paragraphs 45–54 discuss feedback on possible consequential amendments to other IFRS Standards.

13. Consistent with the Board's tentative decision in November 2018, we have not reconsidered the main aspects of the proposed amendments—in particular the proposal to amend the measurement requirements in IAS 16 and require the recognition of sales proceeds in profit or loss.

Staff analysis and recommendations

Modifications to the proposed amendments

The identification of production costs

14. Respondents said the requirement to identify production costs, and distinguish such costs from other costs (cost allocation), would result in entities applying different reporting methods. Many stakeholders said the cost allocation required by the proposed amendments could (a) require extensive use of judgement, and (b) be subject to significant estimation uncertainty. Those stakeholders said the potential diversity in identifying production costs might offset any improvement to financial reporting resulting from recognising sales proceeds in profit or loss.

15. In considering requirements that the Board could develop to help entities identify production costs, we considered whether other IFRS Standards contain requirements on cost allocation that might work well in the context of the sale of items produced before an item of PPE is available for use.

16. IAS 2 includes requirements that apply to all inventories, except those mentioned in paragraph 2 of that Standard. Paragraphs 9–33 of IAS 2 specify how an entity measures inventories, and in particular sets out requirements regarding the cost of inventories. Paragraph 14 of IAS 2 specifies cost allocation requirements that apply in situations similar to that which arises when items are produced while making an item of PPE available for use:

> A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production…

17. We think the Board could consider requiring entities to apply the requirements in paragraphs 9–33 of IAS 2 to identify and measure items produced before an item of PPE is available for use. This is because:

    (a) we are not aware of significant difficulties in applying the existing requirements in IAS 2 on cost allocation, and we think those requirements could work well in identifying and measuring production costs. We understand that the requirements in IAS 2 are well-understood.

    (b) the requirements in IAS 2 set out a framework to identify production costs without being overly prescriptive. Some respondents consulted during our outreach activities said entities are well-positioned to identify and apply a cost allocation methodology that is consistent with the requirements in IAS 2. Respondents who supported further standard-setting had differing views on how prescriptive the Board should be—some suggested that the Board develop only high-level principles on cost allocation while others suggested more detailed application guidance. Committee members who supported proceeding with the proposed amendments recommended that the Board keep any further standard setting at a high-level. We think the requirements in IAS 2 strike an appropriate balance in this regard.

(c) if an entity determines that the sale of items produced before intended use is part of its ordinary activities, it would already be required to apply the requirements in IAS 2 to production costs[3]—this is because the items produced would meet the definition of inventories in IAS 2. We think it would be beneficial to have the same requirements for all production costs.

18. Agenda Paper 12B for the November 2018 Board meeting explained that a few 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).

19. Consistent with our analysis in paragraph 17 of this paper, we do not recommend requiring the use of any one of those methodologies. We expect an entity to apply a methodology that is:

(a) appropriate to the facts and circumstances; and

(b) complies with the requirements in IAS 2.

20. To help entities identify such a methodology, we think the Basis for Conclusions on the final amendments could carry forward some Board observations included in the Exposure Draft (see paragraphs BC8—BC9 of the Exposure Draft reproduced in the Appendix to this paper). Some respondents said those observations are helpful because:

(a) they could assist entities in developing a cost allocation methodology (in particular, paragraph BC9).

[3] Paragraphs 23–29 of this paper discuss further whether the sale of items produced before intended use are part of an entity's ordinary activities.

(b) they outline the situations in which existing Standards already require cost allocation and that might also apply in identifying production costs (in particular, paragraph BC8).

Staff recommendation regarding production costs

21. Based on our analysis, we recommend that the Board amend IAS 16 to require an entity to identify and measure the cost of items produced before an item of PPE is available for use applying the measurement requirements in paragraphs 9–33 of IAS 2.

Presentation and disclosure requirements

22. Some respondents questioned whether the recognition of sales proceeds and production costs in profit or loss would provide useful information. This is because, in their view, such proceeds are not necessarily part of an entity's ordinary activities and may not be representative of sales (and related production costs) that will occur after the item of PPE is available for use—in other words, those stakeholders said sales proceeds may have limited predictive value. Accordingly, some of those stakeholders suggested that the Board consider whether specific presentation or disclosure requirements are necessary to enable financial statement users to identify sales proceeds and production costs.

23. In considering whether the Board should develop presentation or disclosure requirements, we first assessed which IFRS Standards apply to those proceeds and costs.

24. IFRS 15 applies to 'all contracts with customers', except those mentioned in paragraph 5 of that Standard. IFRS 15 defines a 'customer' as follows:

> A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

25. IAS 2 applies to all inventories, except those mentioned in paragraph 2 of that Standard. IAS 2 defines inventories as follows (emphasis added):

> Inventories are assets:
>
> (a) *held for sale in the ordinary course of business*;
>
> (b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

26. Accordingly, if an entity assesses and concludes that the sale of items produced before intended use is output of its ordinary activities[4], we would expect:

    (a) the proceeds to represent revenue within the scope of IFRS 15; and

    (b) the related production costs to be accounted for as inventories within the scope of IAS 2.

27. The Board did not propose additional presentation or disclosure requirements on sales proceeds and related production costs because the Board expected the sale of items produced to be output of an entity's ordinary activities. However, many respondents disagreed with the Board. Those respondents said the sale of such items is not part of an entity's ordinary activities because:

    (a) the sale arises from activities (testing activities in particular) that do not occur on a regular basis;

    (b) the 'ordinary activities' phase starts when an item of PPE is available for use; and

    (c) the sale relates to items that are different (either in nature or quality) from those that the entity sells once the item of PPE is available for use.

28. We continue to agree with the Board and think that items produced while making an item of PPE available for use would generally be part of an entity's ordinary activities. Nonetheless, if an entity assesses and concludes that the sale of items produced are *not* part of its ordinary activities, the requirements in IFRS 15 and IAS 2 would not apply. We have not identified any particular IFRS Standard that would apply in this situation. Accordingly, we would expect an entity to apply the requirements in paragraphs 10–11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to develop and apply an accounting policy.

29. Applying paragraph 11(a) of IAS 8, an entity might conclude that the requirements in IFRS 15 and IAS 2 apply if the entity considers the sale of items produced before

[4] We think the terms 'ordinary activities' and 'ordinary course of business' have the same meaning. For ease of reference, we use the terminology 'ordinary activities' throughout this paper.

intended use to be similar and related to the sale of items produced that are an output of its ordinary activities. However, an entity might not always reach that conclusion. We have therefore considered separately whether and what requirements the Board might develop for sales that are, and are not, part of an entity's ordinary activities.

Sales are part of an entity's ordinary activities

30. Paragraph 110 of IFRS 15 specifies an objective for the disclosure of revenue. As explained in paragraph BC330, this objective enables an entity to assess the overall quality and informational value of its revenue disclosures. Paragraph 110 states:

> The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:
>
> (a) its contracts with customers (see paragraphs 113–122); …

31. Paragraph 111 states:

> An entity shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. An entity shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics.

32. Paragraphs 114–115 set out disclosure requirements specifically regarding the disaggregation of revenue. In particular, paragraph 114 states:

> 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 apply the guidance in paragraphs B87–B89

> when selecting the categories to use to disaggregate revenue.

33. We think that when sales proceeds are material, an entity would consider whether it disaggregates those sales proceeds by considering the requirements in paragraph 111. If disaggregation would provide useful information, the entity would provide information about sales proceeds (for example, the nature, amount and timing), thereby enabling financial statements users to understand how those sales proceeds affect the entity's financial performance.

34. In situations in which production costs are material, we would expect an entity to provide the information required by paragraphs 36–39 of IAS 2 regarding the costs of producing inventories. This information includes the accounting policy adopted in measuring production costs, the carrying amount of inventories and the amount of inventories recognised as an expense.

35. We think those disclosures provide useful information about costs because they help financial statements users to understand:

    (a) the policy that an entity has applied to perform the cost allocation, and thus the extent of judgement involved; and

    (b) how the sales of items produced before an item of PPE is available for use affects the entity's financial performance.

36. We also note that cost allocation would result in estimating production costs. Should the estimation process result in significant measurement uncertainty, we would expect an entity to provide the information about sources of estimation uncertainty set out in paragraphs 125–133 of IAS 1 *Presentation of Financial Statements*. In particular, paragraph 125 of IAS 1 states:

> An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:
>
> (a) their nature, and

(b) their carrying amount as at the end of the reporting period.

37. Accordingly, we think the existing requirements in IAS 1, IAS 2 and IFRS 15 are sufficient to address concerns raised by stakeholders about the relevance of information about sales proceeds and production costs. Consequently, we recommend no further standard-setting in this respect.

Sales are not *part of an entity's ordinary activities*

38. An entity would apply neither IFRS 15 nor IAS 2 if it concludes that the sale of items produced before intended use (a) is not output of its ordinary activities, and (b) is not similar and related to the sale of items that is output of its ordinary activities.

39. We think, in this situation, the Board should consider developing further requirements to supplement the proposed amendments. This is because feedback indicates that sales proceeds and production costs may not be representative of future margins and cash flows that an entity expects to derive from an item of PPE once the asset is available for use. Accordingly, developing specific presentation or disclosure requirements in this respect could be helpful to financial statement users.

40. Agenda Paper 12B for the November 2018 Board meeting explains why sales proceeds and related production costs meet the definition of income and expenses in the 2018 *Conceptual Framework for Financial Reporting* and, accordingly, should be recognised in profit or loss. Although the recognition of income and expenses in profit or loss should not be determined based on whether they are representative of future income and expenses, we think feedback on the proposed amendments suggests that it would be beneficial to require entities to:

    (a) identify sales proceeds and related production costs recognised in profit or loss; and

    (b) provide information about any judgements involved in determining production costs and any related estimation uncertainties.

41. Accordingly, we recommend that the Board require an entity to:

    (a) disclose separately the amount of (i) sales proceeds and (ii) related production costs recognised in profit or loss; and

    (b) specify the line item(s) in the statement of profit or loss that include(s) the sales proceeds and production costs.

42. We considered but decided not to recommend developing further requirements for:

    (a) the presentation of sales proceeds and related production costs in profit or loss. This is because we expect an entity to apply the relevant requirements in IAS 1 when assessing whether to:

        (i) offset sales proceeds and related production costs (paragraphs 32–35 of IAS 1); and

        (ii) present sales proceeds and related production costs as a separate line item(s) in the statement of profit or loss (paragraph 85 of IAS 1).

    (b) the specific disclosure of information about:

        (i) the accounting policy applied to determine production costs. This is because paragraphs 117 of IAS 1 already contains similar requirements.

        (ii) the judgements that the entity's management has made in the process of applying an accounting policy to determine production costs. This is because paragraph 122 of IAS 1 already contains similar requirements.

        (iii) the uncertainties related to how the entity has determined production costs. This is because the requirements in paragraphs 125–133 of IAS 1 already contain similar requirements.

Staff recommendations regarding presentation and disclosure requirements

43. We recommend that the Board not develop presentation and disclosure requirements for the sale of items to which an entity applies IFRS 15 and IAS 2.

44. For the sale of items that are not part of an entity's ordinary activities (and to which an entity does not apply IFRS 15 and IAS 2), we recommend that the Board require entities to:

(a) disclose separately the amount of (i) sales proceeds and (ii) related production costs recognised in profit or loss; and

(b) specify the line item(s) in the statement of profit or loss that include(s) the sales proceeds and costs.

Question 1 for the Board

Do Board members agree with our recommendations as set out in paragraphs 43–44 of this paper?

Consequential amendments to other IFRS Standards

IFRS 6

Background

45. IFRS 6 specifies the accounting for the exploration for and evaluation of mineral resources (E&E). IFRS 6 requires an entity to determine an accounting policy specifying which E&E expenditures are recognised as assets. Paragraph 8 of IFRS 6 requires an entity to measure E&E assets at cost. However, IFRS 6 does not specify how an entity accounts for any proceeds received during the E&E phase.

46. We understand that some entities in the extractive industry apply the existing requirements in paragraph 17(e) of IAS 16 to their E&E assets applying paragraph 11(a) of IAS 8 (ie they deduct any proceeds received during the E&E phase from the cost of the E&E assets).

Feedback

47. A few respondents said the proposed amendments would apply only to assets in the scope of IAS 16. These respondents suggested that the Board clarify whether the proposed requirements would also apply to sales proceeds received during the E&E phase. One respondent said clarifying this would be important because the transitional relief provided in the proposed amendments (see paragraph 9 of this

paper) would not otherwise be available to entities applying the existing requirements in IAS 16 to E&E assets.

Staff analysis and recommendation

48. In our view, specifying how an entity accounts for any proceeds received during the E&E phase goes beyond the scope of the proposed amendments to IAS 16. There are no requirements in IFRS 6 similar to those in paragraph 17(e) of IAS 16 that the Board could or should consequently amend.

49. We note that the Board does not usually specify transition requirements for entities that have applied requirements in IFRS Standards applying paragraph 11(a) of IAS 8.

50. Accordingly, we recommend the Board not extend the scope of the proposed amendments to E&E assets.

Amendments to IFRIC Interpretation 20

Background

51. The Board proposed amending paragraph 2 of IFRIC 20 to specify that stripping costs are accounted for applying IAS 16.

Feedback

52. A few respondents asked for clarity on the proposed consequential amendment to paragraph 2 of IFRIC 20. They suggested any final amendment to IFRIC 20 also make a reference to IAS 38 *Intangible Assets*.

Staff analysis and recommendation

53. The proposed amendment to IFRIC 20 was editorial in nature. The Board intention was not to reconsider the Committee's consensus included in this Interpretation.

54. In the light of the feedback, we recommend the Board not proceed with the proposed editorial amendment to IFRIC 20.

Question 2 for the Board

Do Board members agree with our recommendations sets out in paragraphs 50 and 54 of this paper?

Appendix––Extracts from the Basis for Conclusions on the Exposure Draft

Prohibit deducting sales proceeds from the cost of an item of property, plant and equipment

…

BC8 The Board observed that an entity would have to apply judgement in identifying the costs that relate to items produced and sold before an item of property, plant and equipment is available for use, and to distinguish those costs from other costs incurred before that date. However, the proposed amendments would require little more judgement beyond that already required to apply IFRS Standards. For example, an entity is already required to identify and distinguish the following:

(a) costs directly attributable to making an item of property, plant and equipment available for use, which the entity includes in the cost of the asset;

(b) costs of bringing inventories to their present location and condition included as part of the cost of inventories (paragraph 10 of IAS 2 *Inventories*), which it then recognises in profit or loss at the time that the inventories are sold;

(c) costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred, such as abnormal amounts of wasted materials, labour or other production costs (paragraph 16 of IAS 2);

(d) costs of stripping activity assets and cost of inventories produced during the production phase of a surface mine (IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine*); and

(e) costs that it recognises directly in profit or loss, for example:

(i) administrative, marketing or staff training costs (paragraph 19 of IAS 16);

(ii) costs of using or redeploying property, plant and equipment (paragraph 20 of IAS 16); and

(iii) costs of incidental operations (paragraph 21 of IAS 16).

BC9 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 property, plant and equipment is being tested are costs of inventories or costs of testing (included in the cost of the item of property, plant and equipment), 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 property, plant and equipment available for use or to bring inventories to their present location and condition.

…

Other matters

Disclosure requirements

BC24 The Board considered whether disclosures already required by IFRS Standards are sufficient to provide useful information in the context of the proposed amendments. The Board observed that the most common items produced by an item of property, plant and equipment before it is available for use are inventories produced during testing of the asset. If the asset 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. Consequently, proceeds from selling inventories produced would represent revenue within the scope of IFRS 15 *Revenue from Contracts with Customers*.

BC25 If revenue and the cost of inventories produced before an item of property, plant and equipment is available for use has a material effect on an entity's financial statements, the entity would disclose:

(a) the information required by IFRS 15. In particular, the entity might consider revenue from sale of those inventories as a category of revenue when disclosing information required by paragraph 114 of IFRS 15.

(b) the information required by IAS 2 regarding the costs of producing inventories; for example, the accounting policy adopted, the carrying amount of inventories (if any), and the amount of inventories recognised as an expense.

BC26 In the light of the requirements in IFRS 15 and IAS 2, the Board proposes no additional disclosure requirements. The Board concluded that the existing requirements are sufficient to require an entity to disclose relevant information about the sale of output produced before an item of property, plant and equipment is available for use.