STAFF PAPER

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IFRS Interpretations Committee Meeting

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

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Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request to clarify whether any excess of proceeds received from selling items produced when testing an item of property, plant and equipment (PPE), over the costs of that testing, should be recognised in profit or loss or as a deduction from the cost of the asset.

2. In May 2015, the Interpretations Committee tentatively decided to develop an Interpretation on the meaning of testing, focusing on the meaning of 'functioning properly' in paragraph 17(e) of IAS 16 *Property, Plant and Equipment*. The Interpretations Committee tentatively concluded that functioning properly is an assessment of the technical and physical performance of the PPE asset. The assessment of functioning properly does not include an assessment of financial performance, such as the level of operating margin or the quantity of the output as intended by management.

3. The Interpretations Committee considered that quantitative disclosure of the amount of proceeds that has been deducted from the PPE asset is important for users to understand the effect on the financial statements. The Interpretations Committee tentatively decided that the existing disclosure requirements in IAS 16 were relevant and should be referenced to in the draft Interpretation.

4. The staff draft of the draft Interpretation is included in Agenda Paper 03A to facilitate the discussion on substantial issues. Editorial comments may be given to the staff outside of the meeting.

5. We informally briefed IASB members about the issue and received some specific questions for clarification from them. We also informally shared the draft Interpretation with the Interpretations Committee members to hear comments. In addition, we also received an unsolicited comment from a constituent. These questions and comments are addressed in this paper.

Paper structure

6. This paper is organised as follows:

   (a) informal feedback from IASB members, Interpretations Committee members and another constituent;

   (b) the issues noted based on the feedback;

   (c) transition and first-time adoption; and

   (d) next steps.

Informal feedback from IASB members, Interpretations Committee members and another constituent

7. We consulted IASB members at various meetings in June 2015 to inform them of the tentative decisions taken by the Interpretations Committee and to obtain their individual views on this issue. We did not ask the IASB members to make any decisions when we consulted them.

8. In summary, the informal comments arising from IASB members were as follows:

   (a) most IASB members thought that the approach developed by the Interpretations Committee was appropriate. Some IASB members noted that, when inventory is sold to a customer in the course of an entity's ordinary activities, the activity is no longer testing and the proceeds should be treated as revenue instead of deducting it from the asset. A few IASB members questioned whether there should be no deduction of proceeds from the item of PPE. This is considered further in paragraphs 20–39 of this paper (Issue 2(a), (b), (c)).

(b) some IASB members thought that the proposed approach is consistent with the cessation of capitalisation of software costs in US GAAP (ASC Topic 985-20-25-6), which states that 'capitalization of computer software costs shall cease when the product is available for general release to customers'.

(c) a few IASB members noted that a similar issue was discussed during the development of the June 2014 amendments to IAS 16 to include bearer plants in the scope of IAS 16. In that discussion of the bearer plants project, stakeholders expressed the view that it is difficult to apply judgement about when the bearer plants become ready for use. This is considered further in paragraphs 40–41 of this paper (Issue 2(d)).

(d) a few IASB members suggested that the Interpretations Committee should consider the principles described for the cessation of capitalisation in IAS 23 *Borrowing Costs*. This is considered further in paragraphs 43–49 of this paper (Issue 3(a), (b), (c)).

(e) one IASB member was concerned about including the proposed disclosure paragraph in the draft Interpretation, because the inclusion of the disclosure paragraph may mislead stakeholders. This is considered further in paragraphs 50–51 of this paper (Issue 4).

(f) one IASB member considered that specific illustrative examples should be developed. Specific examples are included in the draft Interpretation in Agenda Paper 03A.

(g) some IASB members thought that an approach similar to IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* should be taken for the situations similar to those described in IFRIC 20. This is considered further in paragraphs 11–17 of this paper (Issue 1 (a)).

9. We shared the draft Interpretation with the Interpretations Committee members to hear their comments. The following issues were identified in their comments:

   (a) one Interpretations Committee member was concerned that the draft interpretation would cause a significant change in practice in extractive industries. This is considered further in paragraphs 11–17 of this paper (Issue 1(a)).

   (b) a few Interpretations Committee members noted that Illustrative Examples should include examples related to extractive industries. This is considered further in paragraph 19 of this paper (Issue 1(c)).

   (c) a few Interpretations Committee members considered that ‘functioning properly’ and ‘capable of operating in the manner intended by management’ would include assessment of throughput/yield/design capacity intended by management. This is considered further in paragraphs 25–31of this paper (Issue 2(b)).

   (d) one Interpretations Committee member considered that the timing of assessments of ‘functioning properly’ and ‘capable of operating in the manner intended by management could be different. That Interpretations Committee member questioned, in that case, how an entity determines the cost of inventory produced when an asset is functioning properly but not capable of operating in the manner intended by management, without depreciation cost. This is considered further in paragraphs 32-39 of this paper (Issue 2(c)).

   (e) one Interpretations Committee member considered that the guidance for the cessation of capitalisation should be similar to that in IAS 23. That Interpretations Committee member also thinks that the issue of proper componentisation should be addressed. This is considered further in paragraphs 43-49 of this paper (Issues 3(a), (b), (c)).

10. We also received a concern from a constituent in which they noted that there is a case in which an extractive entity seems to have recognised zero cost inventories

before the PPE asset becomes ready for use that are sold *after* the PPE asset becomes ready for use. In this case, the proceeds received after the PPE asset became ready for use were recognised as revenue in profit or loss; however, the corresponding costs of goods sold seemed to be zero. This was because the costs incurred before the PPE asset became ready for use, including all costs incurred in producing the inventory, were recognised as costs of the PPE asset. The constituent wondered whether it is appropriate to recognise revenue without a corresponding cost of goods sold. This is considered further in paragraphs11-17 of this paper (Issue 1(a)).

The issues noted based on the feedback

Issue 1: Issues relating to extractive industries

(a) Applicability of the Interpretation to extractive industries

11. One Interpretations Committee member was concerned that the proposed accounting would cause a significant change in practice in the mining industry. That Interpretations Committee member considered that there is currently no diversity in practice. That Interpretations Committee member also noted that the predominant practice in the extractive industries is to deduct the proceeds from the cost of the PPE asset, until the point at which the asset is capable of operating in the manner intended by management. This is in contrast to the narrower focus proposed in the draft Interpretation, of limiting the deduction of proceeds to the activity of testing if the asset is functioning properly. The point at which a mine commences commercial production is often used to determine the point at which the asset is ready for use and judgement is required to determine this point.

12. We understand that saleable items could be extracted from a mine before commercial production is reached. For example, when building a deep-level mine, a tunnel has to be constructed to access the ore body. When the tunnel is constructed, a mix of ore and waste is extracted. The ore can be sold, and as a result, the entity receives proceeds before the mine is ready for use.

13. The tentative decision made by the Interpretations Committee was that only proceeds that relate to testing should be deducted from the PPE asset, in accordance with paragraph 17(e) of IAS 16. On this basis, the appropriate question is whether the activity that led to those proceeds was testing. However, the activity above, which is described in paragraph 12 of this paper, does not seem to be testing whether the PPE asset is functioning properly, even though we think that the extraction of that mix of ore and waste would be part of the construction of the mine.

14. We also received a concern from a constituent in which they noted a case in which an extractive entity seems to have recognised zero cost inventories *before* the PPE asset becomes ready for use that are sold *after* the PPE asset became ready for use, according to the disclosures given in the notes to the financial statements about production volume and sales volume. In this case, the proceeds received after the PPE asset became ready for use (at commercial production) were recognised as revenue in profit or loss, according to its disclosure; however, the corresponding costs of goods sold appeared to be capitalised as PPE rather than being allocated to inventory. The constituent questioned whether it is appropriate to recognise revenue without a corresponding cost of goods sold, and whether this was consistent with paragraph 34 of IAS 2.

15. Having analysed the concern raised by the constituent, we noted that the fact pattern is similar to the one addressed in IFRIC 20. Some IASB members thought that an approach similar to IFRIC 20 should be taken for situations similar to those described in IFRIC 20. Paragraph 8 of IFRIC 20 requires:

> 8 To the extent that the benefit from the stripping activity is realised in the form of inventory produced, the entity shall account for the costs of that stripping activity in accordance with the principles of IAS 2 *Inventories*. To the extent the benefit is improved access to ore, the entity shall recognise these costs as a non-current asset, if the criteria in paragraph 9 below are met.

16. We noted that the scope of IFRIC 20 is specifically limited to the production phase of a surface mine. However, we think that if a similar fact pattern is observed in the cases outside of the scope of IFRIC 20, for example, inventory is

produced during the construction of a deep mine in the development phase, the same principle in IFRIC 20 could be applied, by analogy, by allocating costs between the inventory produced and the cost of the PPE asset constructed.

17. We considered whether the scope paragraph of IFRIC 20 should be expanded to accommodate application to both deep mines and to the development phase of a mine, but we considered that this is not necessary. This is because paragraph 11(a) of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires management to refer the requirements in IFRSs dealing with similar and related issues when there is not specific guidance for a particular transaction or circumstance. We think that the fact pattern described in paragraph 12 of this paper and that of IFRIC 20 are similar and related.

(b) Diversity in practice in extractive industries

18. An Interpretations Committee member commented that there seems to be no diversity in practice in extractive industries. However, we noted that the results of outreach activities described in previous papers[1] presented a different experience.

(c) Illustrative Example related to extractive industries

19. A few Interpretations Committee members asked for the inclusion of Illustrative Example related to extractive industries. We have added an example related to the extractive industries. Please see Example 3 in the attached Agenda Paper 03A.

[1] Paragraph 15 (a) of Agenda Paper 09 of the November 2014 meeting.
http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2014/November/AP09%20-%20IAS16%20Accounting%20for%20proceeds%20and%20costs%20of%20testing%20PPE.pdf
Paragraph 36-42 of Agenda Paper 03A of January 2015 meeting.
http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2015/January/AP03A%20-%20IAS16%20Accounting%20for%20proceeds%20and%20costs%20of%20testing%20PPE%20Summary%20of%20outreaches%20revised%2020%20Jan.pdf
Paragraph 10 of Agenda Paper 02 of May 2015 meeting.
http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2015/May/AP02%20-%20IAS16%20Accounting%20for%20proceeds%20and%20costs%20of%20testing%20PPE.pdf

Questions for the Interpretations Committee
1. What comments does the Interpretations Committee have on the staff analysis on the applicability of this Interpretation to the fact pattern in the extractive industry described in paragraph 12 of this paper? 2. Does the Interpretations Committee agree that the principle described in IFRIC 20, rather than the draft Interpretation, should be applied to the fact pattern in the extractive industry described in paragraph 12 of this paper? 3. Does the Interpretations Committee agree that it is not necessary to change the scope paragraph of IFRIC 20?

Issue 2: Interaction between IAS 2 and IAS 16

(a) Interaction between IAS 2 and IAS 16

20. Some IASB members noted that, when inventory is sold to a customer in an entity's ordinary course of business, the activity is no longer testing and the proceeds should be treated as revenue instead of deducting them from the asset.

21. Paragraph 6 of IAS 2 *Inventories* states that inventories are 'assets held for sale in the ordinary course of business'. Paragraph 10 of IAS 2 states that the cost of inventories shall comprise all costs incurred in bringing the inventories to their present location and condition. Paragraphs 6 and 10 of IAS 2 state as follows:

> 6 The following terms are used in this Standard with the meanings specified:
>
> Inventories are assets:
>
> (a) held for sale in the ordinary course of business;
>
> (b) …
>
> 10 The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

22. We think that if a PPE asset produces an item that meets the definition of inventory sold in the ordinary course of business, the cost incurred to produce the inventory should be recognised as the cost of the inventory, in accordance with paragraphs 6 and 10 of IAS 2. Accordingly, we agree with the comment that, when inventory is sold to a customer in an entity's ordinary course of business, that activity is no longer testing.

23. However, we think that it is necessary to understand the boundary between IAS 2 and IAS 16. In particular, we considered the question of when an item that is produced from a PPE asset should be considered to result from the testing of the asset and when it should be considered to be the production of inventories.

24. Paragraph 17(e) of IAS 16 requires that the costs of testing are included in the cost of the PPE asset, whereas IAS 2 requires that the cost of inventories is recorded as an inventory asset. Furthermore, paragraph 34 of IAS 2 states that when inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. Before we conclude on the boundary between IAS 2 and IAS 16, we think we need to consider how throughput/yield/capacity intended by management affects the judgements. Please see the discussions below.

(b) Whether the judgement 'functioning properly' and 'capable of operating in the manner intended by management' should include consideration of throughput/yield/capacity intended by the management in all respects

25. A few Interpretations Committee members commented that the judgement on whether an asset is 'functioning properly' in paragraph 17(e) of IAS 16 and 'capable of operating in the manner intended by management' in paragraph 16 of IAS 16 should include consideration of throughput/yield/capacity intended by management. They note that testing the level of throughput/yield/capacity intended by the management would inevitably involve producing items from the PPE at volumes consistent with that level of throughput/yield/capacity. They think that until this testing is completed, the PPE cannot be assessed as functioning properly.

26. In analysing this issue, we consider the following views:

    (a) View A—management may use a predetermined throughput/yield/capacity as a criterion to establish when to cease capitalising costs of PPE assets, regardless of the level of inventory produced or revenue earned in the ordinary course of business; and

    (b) View B—capitalisation of costs of PPE assets ceases when the PPE asset produces the output that meet the definition of inventory, at a quantity level that enables the entity to sell the item in the ordinary course of business. This operation would not necessarily be at the levels of throughput/yield/capacity intended by management.

27. In View A, it is argued that the testing process continues until the asset become capable of achieving the level of throughput/yield/capacity intended by management in all respects. In this view, when determining whether the asset is functioning properly or capable of operating in the manner intended by management, an entity might continue to classify the asset as not yet functioning properly or capable of operating in the manner intended by management until the asset is proven capable of achieving a specific level of throughput/yield/capacity, regardless of the level of inventory produced or revenue earned from this activity. In support of this view, it is argued that:

    (a) achieving the throughput/yield/capacity is part of the testing of the technical and physical capabilities of the asset. Consequently, this is part of the testing that the asset is functioning properly.

    (b) the current Standard seems to allow for management judgement in determining when the asset is ready for use. Paragraph 20 of IAS 16 states that recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating 'in the manner intended by management'.

    (c) View A acknowledges that paragraph 20(a) of IAS 16 explains that the costs incurred after the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management should not be included in the carrying amount of the asset. In explaining this requirement, it gives the example of costs incurred when the asset is operated at less than full capacity, which are to be excluded from the carrying amount of the asset. However, in support of View A it is argued that paragraph 20(a) does not preclude making the judgement solely depending on whether the asset can operate at its design capacity, because 'being operated at less than full capacity' and 'whether the asset is capable of operating at its design capacity' are different.

28. View B also acknowledges the necessity to consider that throughput/yield/capacity when making a judgement whether the PPE asset is 'capable of operating in the manner intended by management'. View B does not consider that the successful production of the first piece of the inventory automatically triggers the judgement that the asset is capable of operating in the manner intended by management. However, View B also considers whether the PPE asset produces the output that meets the definition of inventory, at a quantity level that enables the entity to sell the items produced in the ordinary course of business. This operation would not necessarily be at the levels of throughput/yield/capacity, intended by management. In support of this view, it is argued that:

(a) In many industries, entities may start production before management achieves the intended throughput/yield/capacity. These entities achieve the level of throughput/yield/capacity intended by management through continuous improvement process during its operation. This view arises from a concern that in View A, different management intentions on the level of throughput/yield/capacity could result in different pattern of revenue recognition. For example, it is common for semiconductors to start production while the yield rate (percentage of good chips on a wafer) is low, and subsequently achieve the acceptable level of yield rate intended by management in one year or so. Although the yield rate is not as high as intended by management in the beginning, entities produce products and sell them to the customers in the ordinary course of business. The question is whether the revenue does not need to be recognised on profit or loss depending on management's intention for the level of throughput/yield/capacity, although inventories are sold to customers in the ordinary course of business.

(b) View B acknowledges that testing the capacity of an asset for a short period of time would be a necessary step, which is compatible with paragraph 17(e) of IAS 16. Accordingly, testing the capacity of an asset for a short period of time can be distinguished from the description of an asset 'operating at less than full capacity' set out in paragraph 20(a) of IAS 16. On the other hand, View B takes into account a concern that if the intended level of throughput/yield/capacity is set particularly high and cannot therefore be achieved in a short period of time, the testing period can be quite long and could continue even after an entity starts selling products in the ordinary course of business. Accordingly, View B considers that a distinction should be made between the testing period necessary to test the capacity of the PPE asset and continuous operations selling the products in the ordinary course of business.

(c) The draft Interpretation provides clarification that an entity shall deduct proceeds received from the cost of an asset even if the proceeds received exceed costs of testing, in response to the original submission. If deduction of proceeds from the cost of the PPE asset was permitted without any limitation, this could result in diversity in practice regarding when the asset is ready for use, depending on a specific level of throughput/yield/capacity intended by management.

(d) The example considered by View B is as follows. A manufacturing company develops a new electrical appliance. The management intends to produce and sell the appliance at a rate of 3 million appliances per month; however, because of technical difficulties, the production facility can only produce 1 million appliances per month. Although the yield rate is only 33 per cent of the level intended by management, the production volume of the appliances is sufficient for the company to sell it in the ordinary course of business. The company decides to launch this new product with an advertising campaign. One year later, the company manages to improve the yield rate to the level that it had originally intended. In this example, View B considers that the revenue and costs of goods sold should be recognised in profit or loss during the first year, because the PPE asset produces output that meets the definition of inventory, at a quantity level that enables the entity to sell the items produced in the ordinary course of business. In this case, the asset would be ready for use in View B; however, in View A the asset may or may not be ready for use, depending on management's intention.

29. We consider that View B would result in providing more useful information to the users of financial statements, because it results in recognition of revenue and costs in profit or loss, when an entity sells inventory in the ordinary course of business.

30. We noted that some IASB members questioned whether we should consider an approach that prohibits any deduction of proceeds. However, we do not propose to consider that approach, because we think that testing is a necessary part of constructing an asset, and the net cost of testing is appropriately included in the carrying amount of the asset.

31. We acknowledge that View B also involves judgements such as the quantity level that enables the entity to sell the items produced in the ordinary course of business, however, we consider that View B results in narrower judgement and also leads to a result that is more consistent with the requirements in IAS 2.

(c) Would there be operations in which a PPE asset is 'functioning properly' but is not yet 'capable of operating in the manner intended by management'—timing of assessments

32. One Interpretations Committee member questioned how an entity determines the cost of 'inventory' produced when a PPE asset is functioning properly but is not yet capable of operating in the manner intended by management. The Interpretations Committee member noted that this draft Interpretation proposes to

clarify that the testing process ceases when the PPE asset is functioning properly (ie after the PPE asset is functioning properly, output produced is recognised as inventory), whereas the depreciation of the PPE asset does not begin until the PPE asset is in the location and condition necessary for it to be capable of operating in the manner intended by management, in accordance with paragraph 55 of IAS 16. Accordingly, that Interpretations Committee member was concerned that depreciation expense would not be allocated to the 'inventory' produced during the operation *after* the asset is functioning properly but *before* the asset is yet capable of operating in the manner intended by management.

33. We analysed this issue in the following order:

    (a) are there cases in which a PPE asset is 'functioning properly' but is not yet 'capable of operating in the manner intended by management'?

    (b) if the answer to the question above is 'Yes', would there be any operation during the period when a PPE asset becomes 'functioning properly' but is not yet 'capable of operating in the manner intended by management'? If so, is it appropriate that no depreciation is recognised during the operation?

34. We think that, in many cases, the timing of when the PPE is first considered to be 'functioning properly' and the timing of when it becomes 'capable of operating in the manner intended by management' would be the same. This is because we think that the purpose of testing to determine whether the PPE asset is functioning properly is to assess whether the asset is capable of operating in the manner intended by management.

35. However, we think that there could be cases in which a PPE asset is determined as functioning properly but is not yet 'capable of operating in the manner intended by management.' For example, if the PPE asset (machine) is tested in a testing facility outside of a factory and is later moved to the factory; the timing of when the asset is considered to be functioning properly and the timing of when the asset is capable of operating in the manner intended by management would be different.

36. In the case above, there would be no operation during the time after the asset is functioning properly but before it is capable of operating in the manner intended

by management, because the PPE asset would start its operation after being moved to the factory (after becoming capable of operating in the manner intended by management). However, the question is: could there be other circumstances that management operates a PPE asset, when the PPE asset is ‘functioning properly’ but is not yet ‘capable of operating in the manner intended by management’?

37. For example, in a similar case, the machine could be tested at a temporary facility to determine if it is functioning properly, and could then be operated at that temporary facility while a dedicated factory is constructed in which to house the machine. If, in this circumstance, the construction of the dedicated factory took one year to complete, then some might argue that the machine is functioning properly and producing outputs for a year before it is in the location and condition intended by management (becoming capable of operating in the manner intended by management). The consequence of this conclusion would be that deprecation of the machine would not commence until the machine has been moved to the new factory.

38. We disagree with this argument. We do not think it is appropriate not to recognise depreciation expense in this case. The machine may not be in the location intended (the new factory in this case), but management has already determined that the PPE asset is functioning properly. This means that the PPE asset is capable of producing items that can be sold in the ordinary course of business, in sufficient quantity to enable the entity to sell those items in the ordinary course of business. We think that by deciding to start operating the machine at the temporary location, management have revised their original intention about the location of the machine, notwithstanding their plan to move the machine after one year. Consequently we think that in this circumstance the timing of the machine functioning properly and the timing of it being in the location and condition intended by management (that is capable of operating in the manner intended by management) is the same.

39. Accordingly, we think it unlikely that there would be operation after the asset becomes ‘functioning properly’ but is not yet ‘capable of operating in the manner intended by management’.

Questions for the Interpretations Committee
4. What comments does the Interpretations Committee have on the staff analysis on whether the judgement on 'functioning properly' and 'capable of operating in the manner intended by management' should include consideration on throughput/yield/capacity intended by the management in all respects? 5. Does the Interpretations Committee agree with View B in paragraph 28 of this paper?

(d) Bearer plants

40. A few IASB members noted that a similar issue was discussed during the development of the June 2014 amendments to IAS 16 and IAS 40 *Investment Property* to include bearer plants within the scope of IAS 16. The newly introduced paragraph BC82 states as follows:

> BC82 Most respondents to the ED requested additional guidance on when a bearer plant is in the 'location and condition necessary for it to be capable of operating in the manner intended by management' in accordance with paragraph 16(b) of IAS 16—ie when it is deemed to have reached maturity. For example, an oil palm may start to grow produce after two years, but only reach its maximum yield after seven years. Respondents suggested either defining the date of maturity to be 'the date of the first harvest of commercial value' or 'the date commercial quantities of produce are produced'. The Board noted that without further clarification these terms would not assist entities in applying judgement in this area and would be likely to lead to interpretation requests in the future. The Board also noted that a similar scenario arises for a factory or retail outlet that is not yet capable of operating at full capacity and did not think that this was a major issue in practice. Consequently, the Board decided not to add guidance in this area.

41. We consider that this issue, applying judgement about the 'location and condition necessary for it to be capable of operating in the manner intended by management' to bearer plants, is similar to the issue in the draft Interpretation. In the example of an oil palm, it may start production after two years, but only reach its maximum yield after seven years. From the responses to the ED for the June 2014 amendments to IAS 16, we noted that, some respondents suggested either defining the date of maturity to be 'the date of the first harvest of commercial value' or 'the date commercial quantities of produce are produced'. We do not consider that the approach in View B in paragraph 28 of this paper is contrary to the views expressed by the respondents, because View B considers that the PPE asset is ready for use when the PPE asset produces output that meets the definition of inventory that will be sold in the ordinary course of business, and at a quantity level that enables the entity to sell the items in the ordinary course of business.

(e) Proposed solution

42. We support View B in paragraph 28. Consequently, we think that when a PPE asset is capable of producing items that meets the definition of inventories, at a quantity level that enables the entity to sell the items produced in the ordinary course of business, the items are required to be accounted for in accordance with IAS 2 and therefore cannot be accounted for as part of the costs of testing. Through this analysis, we observed that two criteria must be met in order for the operation of a PPE asset to be classified as testing:

   (a) the activity is necessary in order to determine that the asset is functioning properly, ie it is necessary for testing the technical and physical performance of the asset. The technical and physical testing includes testing the asset's throughput capabilities; and

   (b) the activity does not produce output that meets the definition of inventory, at a quantity level that enables the entity to sell the items produced in the ordinary course of business.

Questions for the Interpretations Committee
6. What comments does the Interpretations Committee have on the proposed solution described in paragraph 42 of this paper? 7. Does the Interpretations Committee agree with the proposed solution described in paragraph 42 of this paper?

Issue 3: Interaction with IAS 23

(a) Interaction with IAS 23

43. A few IASB members suggested that the Interpretations Committee should make sure that the draft Interpretation is consistent with the principles described in IAS 23 for the cessation of capitalisation. One Interpretations Committee member also made similar comments. Paragraphs 22–25 of IAS 23 state as follows:

> 22 An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.
>
> 23 An asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.
>
> 24 When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the entity shall cease capitalising borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.
>
> 25 A business park comprising several buildings, each of which can be used individually, is an example of a

> qualifying asset for which each part is capable of being usable while construction continues on other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

(b) Cease the capitalisation of the cost of PPE

44. We noted that these paragraphs in IAS 23 provide guidance for specific circumstances in which an entity should cease the capitalisation of the cost of PPE. Paragraphs 22–23 of IAS 23 provide certain limitations on the judgement about when the asset is ready for use. We considered whether we should incorporate this guidance such as ‘an entity shall cease capitalising costs when substantially all the activities necessary to prepare the asset for its intended use is complete’ or ‘an asset is normally ready for its intended use when the physical construction of the asset is complete even though routine administrative work might still continue’, however we decided not to do so. This is because the purpose of these paragraphs in IAS 23 is to provide guidance to support the judgement about when the asset is ready for use. We consider that the criteria in the draft Interpretation discussed on paragraph 42 of this paper would also provide relevant guidance to support the judgement about when the asset is ready for use and would not create inconsistency with paragraphs 22–23 of IAS 23.

(c) Componentisation

45. We consider that paragraphs 24–25 of IAS 23 provide useful guidance on the componentisation of an item of PPE.

46. We noted that IAS 16 does not define the term ‘item’; instead, paragraph 9 of IAS 16 states that judgement is needed with respect to the unit of measurement for recognition. We also noted that paragraph 43 of IAS 16 requires the componentisation of fixed assets.

47. We noted from our outreach that the introduction of the concept of componentisation was intended to function regardless of how an 'item (unit of account)' was identified in a particular circumstance. This is because no matter how an item is identified, appropriate componentisation should mean that the accounting will reflect the same economic reality in the same way, regardless of whether the asset is identified as a large item with several components or as a group of smaller items. This highlights the importance of the componentisation assessment.

48. We noted that the judgement on the identification and componentisation of the asset could result in different accounting consequences. This is because when an entity constructs an asset in parts and each part is capable of being used while construction continues on other parts, the entity may receive proceeds before the completion of the construction of the asset as a whole. We learned about an example in which a mine is composed of several pits. The outreach suggested that, if several pits are treated as one component, the asset might not be assessed as ready for use until all the pits are ready for use and significant proceeds may be received before the asset is ready for use. However, if each pit is identified as a separate component, then depreciation of each pit would commence when that pit is ready for use and revenue and costs would be recognised in the income statement.

49. We considered whether guidance on componentisation should be added to the draft Interpretation but propose not to do so, because componentisation is a principle that is already applied in IAS 16 and it would be appropriate to assume that an entity will make its judgement on componentisation properly when applying this draft Interpretation.

Questions for the Interpretations Committee
8. What comments does the Interpretations Committee have on the analysis on the interaction with IAS 23 in paragraph 43–49 of this paper?
9. Does the Interpretations Committee agree that it is not necessary to add guidance on componentisation to the draft Interpretation?

Issue 4: Disclosure requirement about the amount deducted

50. One IASB member was concerned about adding the proposed disclosure paragraph in the Interpretation. Although the key message of the draft Interpretation is that the proceeds should be deducted only for the limited relevant cases, the IASB member thought that adding the disclosure requirement on the amount of proceeds deducted from the cost of PPE asset implies that material proceeds would be deducted from the cost of PPE asset in many cases. Accordingly, the IASB member thought that adding the disclosure requirement could be misleading.

51. We understand the concern; however, we think that there are cases in which material proceeds would be deducted and the disclosure provides transparency in these cases. We also consider that the transparency would encourage consistent application of the draft Interpretation in practice. Accordingly, we think that the disclosure requirement about the amount deducted should be included in the draft Interpretation.

Question for the Interpretations Committee

10. Does the Interpretations Committee agree that the disclosure requirement about the amount of proceeds deducted from the cost of PPE asset should be included in the draft Interpretation?

Transition and first-time adoption

52. We considered the transition requirements for the draft Interpretation. We noted that full retrospective application on transition to the draft Interpretation may be burdensome, because the application of the draft Interpretation could change the original cost basis of an asset and the subsequent depreciation expense. Furthermore, entities may not have sufficient information to make a reliable adjustment of computations. Consequently, we think that, on initial application, entities should have the option of relief from retrospectively adjusting all assets, expenses and income incurred or earned before either the start of the current reporting period or the start of a prior reporting period that is presented in the first reporting period of application.

53. We also considered whether there are significant implications of the draft Interpretation for first-time adopters of IFRS. We considered that full retrospective application of the [draft] Interpretation may also be burdensome for first-time adopters of IFRS, for the same reasons stated in paragraph 52 of this paper. Consequently, we propose that those transition provisions should be available to first-time adopters.

Questions for the Interpretations Committee
11. Does the Interpretations Committee agree that, on initial application, entities should have the option of relief from the retrospective restatement?   12. Does the Interpretations Committee agree to add an exemption for first-time adopters to apply the transition provisions?

Next steps

54. Following this Interpretations Committee meeting, the staff will amend the draft Interpretation in Agenda Paper 03A to reflect the views of the Interpretations Committee. We will also update the Basis for Conclusions of the draft Interpretation to reflect the tentative decisions made at the meeting.

55. If the Interpretations Committee is satisfied that all of the matters necessary in developing the proposals have been addressed, we will ask you to vote at this meeting to determine whether there is general agreement that the staff should prepare the draft Interpretation for balloting (subject to no significant matters arising from the IASB discussions). General agreement is reached when no more than four members have voted against the proposal.

56. In accordance with paragraph 7.7 of the *IASB and IFRS Interpretations Committee Due Process Handbook*, the staff will present a paper to the IASB at one of its future meetings. This paper will summarise the steps that have been taken in developing the proposals and will recommend a comment period for the draft Interpretation. The comment period is usually a minimum period of 90 days.

57. If the Interpretations Committee reaches such general agreement and there are no significant matters arising from the IASB meeting, we will conduct a written ballot of the draft Interpretation.

58. IASB members also receive ballot drafts of the draft Interpretation. If four or more IASB members object to the release of the draft Interpretation during the balloting process, the draft Interpretation is not released. The IASB then

determines the next steps (if any) for the issue (see paragraph 7.10 of the *Due Process Handbook*).

Questions for the Interpretations Committee
13. Does the Interpretations Committee have other substantial comments on the attached draft Interpretation on Agenda Paper 03A (editorial comments may be given to the staff outside of the meeting)? 14. Is the Interpretations Committee satisfied that all relevant matters in developing the proposals have been addressed? 15. Provided that the IASB does not raise any significant matters, does the Interpretations Committee agree that the staff should prepare a ballot draft of the proposed draft Interpretation for public comment?