STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 16 *Property, Plant and Equipment***		
Paper topic	Draft Interpretation—Accounting for proceeds and cost of testing PPE		
CONTACT(S)	Koichiro Kuramochi	kkuramochi@ifrs.org	+44 (0)20 7246 6496

[Draft] IFRIC Interpretation X

Accounting for proceeds received before a property, plant and equipment asset is capable of operating in the manner intended by management

References

- IAS 2 *Inventories*
- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- IAS 16 *Property, Plant and Equipment*

Background

1. An entity that constructs a property, plant and equipment asset may need to test that asset before it can be considered ready for use. The entity may sell items that are produced while it is testing the asset.

2. Paragraph 16(b) of IAS 16 *Property, Plant and Equipment* explains that the cost of a property, plant and equipment asset includes any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Paragraph 17(e) of IAS 16 explains further that the cost of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and

condition (such as samples produced when testing equipment), is an example of a directly attributable cost.

3. The IFRS Interpretations Committee (‘the Interpretations Committee’) received a question about whether any excess of proceeds received from selling items produced when testing an asset, over the costs of that testing, should be recognised in profit or loss or as a deduction from the cost of the asset.

4. IAS 2 *Inventories* provides guidance on the accounting for items that meet the definition of ‘inventory’, which includes assets held for sale in the ordinary course of business.

5. The Interpretations Committee noted therefore that this issue relates to identifying when a property, plant and equipment asset is being tested. When the asset is being tested, the costs incurred, and proceeds received from the sale of items produced during testing, are subject to the guidance in paragraph 17(e) of IAS 16. Other guidance, such as that in IAS 2, may apply when the asset is not being tested.

6. This [draft] Interpretation gives guidance on the meaning of ‘testing whether the asset is functioning properly’, within the context of paragraph 17(e) of IAS 16, in order to clarify which proceeds should be deducted from the cost of the asset. This [draft] Interpretation also gives guidance on how an entity should account for proceeds that are received from the sale of items produced before the asset is capable of operating in the manner intended by management.

Scope

7. This [draft] Interpretation applies to the:

   (a) costs of testing incurred to determine if a property, plant and equipment asset is functioning properly; and

   (b) proceeds received from the sale of items produced from a property, plant and equipment asset, before it is capable of operating in the manner intended by management.

Issue

8. This [draft] Interpretation addresses the following issues:

   (a) clarification of the meaning of 'testing', in paragraph 17(e) of IAS 16; and

   (b) how an entity should account for proceeds that are received from the sale of items produced before the asset is capable of operating in the manner intended by management.

Consensus

Meaning of 'testing' in paragraph 17(e) of IAS 16

9. Testing is part of the process of bringing a property, plant and equipment asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

10. The objective of testing, within this context, is to assess whether the property, plant and equipment asset is functioning properly. That assessment is an assessment of the technical and physical performance of the asset. It is not an assessment of the financial performance of the asset, such as achieving a specific operating margin intended by management.

11. An asset is functioning properly if it is capable of producing items that can be sold in the ordinary course of business, that is, it produces items that meet the definition of inventory in paragraph 6 of IAS 2, at a quantity level which enables the entity to sell those items in the ordinary course of business.

12. Consequently, an item of property, plant and equipment is being tested when, and only when:

   (a) the activity is necessary in order to determine that the asset is functioning properly, ie, it is necessary to test 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.

Recognition of proceeds and costs that arise before an asset is capable of operating in the manner intended by management

13. All costs that are directly attributable to bringing a property, plant and equipment asset to the location and condition necessary for it to be capable of operating in the manner intended by management shall be capitalised as part of the cost of the asset, in accordance with paragraph 16(b) of IAS 16. This includes the costs of testing whether the asset is functioning properly in accordance with paragraph 17(e) of IAS 16.

14. The proceeds received from the sale of items produced from a property, plant and equipment asset while testing whether that asset is functioning properly shall be deducted from the cost of the asset. However, all other proceeds received from the sale of items produced from a property, plant and equipment asset while the asset is being brought to the location and condition necessary for it to be capable of operating in the manner intended by management shall be recognised in profit or loss.

Disclosure

15. An entity is required to disclose a reconciliation of the carrying amount of property, plant and equipment at the beginning and end of the period in accordance with paragraph 73(e) of IAS 16. An entity shall consider whether the proceeds deducted from an asset in accordance with paragraph 17(e) of IAS 16 should be disclosed separately in that reconciliation, to enable users to understand the impact of the proceeds deducted from the cost of property, plant and equipment.

Appendix A

Effective date and transition

This appendix is an integral part of the [draft] Interpretation and has the same authority as the other parts of the [draft] Interpretation.

Effective date

A1. An entity shall apply this [draft] Interpretation for annual periods beginning on or after [date]. Earlier application is permitted. If an entity applies this [draft] Interpretation for an earlier period, it shall disclose that fact.

Transition

A2. On initial application, an entity shall apply this [draft] Interpretation either:

(a) retrospectively to each prior reporting period presented in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; or

(b) prospectively to the costs incurred in testing whether an item of property, plant and equipment is functioning properly, and the proceeds received from the sale of the items produced, while bringing the property, plant and equipment asset to the condition for it to be capable of operating in the manner intended by management that are initially recognised on or after:

(i) the beginning of the reporting period in which an entity first applies the [draft] Interpretation; or

(ii) the beginning of a prior reporting period for which comparative information is presented in the financial statements of the reporting period in which an entity first applies the [draft] Interpretation.

A3 If an entity applies paragraph A2(b) on initial application, the entity:

(a) shall not adjust previously reported financial statements for reporting periods prior to the respective reporting period in paragraph A2(b)(i) or (ii); but

(b) shall apply the [draft] Interpretation to:

(i) the costs incurred in testing whether a property, plant and equipment asset is functioning properly; and

(ii) the proceeds received from items produced, while bringing the property, plant and equipment asset to the condition for it to be capable of operating in the manner intended by management

that are recognised on or after the beginning of the respective reporting period in paragraph A2(b)(i) or (ii).

Proposed consequential amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards*

After paragraph 39AA, paragraph 39AB is added. In Appendix D, paragraph D1 is amended and paragraph D34 is added (new text is underlined and deleted texts are struck through):

<u>39AB IFRIC X *Accounting for proceeds received before a property, plant and equipment asset is capable of operating in the manner intended by management* added paragraph D34 and amended paragraph D1. An entity shall apply that amendment when it applies IFRIC X.</u>

D1 An entity may elect to use one or more of the following exemptions:

(a) share-based payment transactions (paragraphs D2 and D3);

(b) insurance contracts (paragraph D4);

(c) deemed cost (paragraphs D5–D8B);

(d) leases (paragraphs D9 and D9A);

(e) [deleted]

(f) cumulative translation differences (paragraphs D12 and D13);

(g) investments in subsidiaries, joint ventures and associates (paragraphs D14 and D15);

(h) assets and liabilities of subsidiaries, associates and joint ventures (paragraphs D16 and D17);

(i) compound financial instruments (paragraph D18);

(j) designation of previously recognised financial instruments (paragraphs D19–D19C);

(k) fair value measurement of financial assets or financial liabilities at initial recognition (paragraph D20);

(l) decommissioning liabilities included in the cost of property, plant and equipment (paragraphs D21 and D21A);

(m) financial assets or intangible assets accounted for in accordance with IFRIC 12 Service Concession Arrangements (paragraph D22);

(n) borrowing costs (paragraph D23);

(o) transfers of assets from customers (paragraph D24);

(p) extinguishing financial liabilities with equity instruments (paragraph D25);

(q) severe hyperinflation (paragraphs D26–D30);

(r) joint arrangements (paragraph D31);

(s) stripping costs in the production phase of a surface mine (paragraph D32); ~~and~~

(t) designation of contracts to buy or sell a non-financial item (paragraph D33)~~.~~; and

(u) accounting for proceeds received before a property, plant and equipment asset is capable of operating in the manner intended by management (paragraph D34).

An entity shall not apply these exemptions by analogy to other items.

Accounting for proceeds received before a property, plant and equipment asset is capable of operating in the manner intended by management

D34 A first-time adopter may apply the transition provisions set out in paragraphs A1 to A3 of IFRIC X *Accounting for proceeds received before a property, plant and equipment asset is capable of operating in the manner intended by management*. In that paragraph, reference to the effective date shall be interpreted as [date] or the beginning of the first IFRS reporting period, whichever is later.

Appendix B

Application Guidance

This appendix is an integral part of the [draft] Interpretation and has the same authority as the other parts of the [draft] Interpretation.

Recognition of proceeds and costs that arise before an asset is capable of operating in the manner intended by management

B1. This appendix describes the application of paragraphs 13 and 14, which provide guidance on the recognition of proceeds received from selling items produced during the testing of the property, plant and equipment asset.

Accounting for proceeds received from selling items produced when the proceeds exceed costs of testing

B2. The sale of items produced when testing a property, plant and equipment asset may exceed the costs of testing the asset, including the cost of raw materials used in that testing, in some circumstances. The value of proceeds received does not change the nature of the activity being undertaken; the testing process remains a necessary part of determining if the asset is functioning properly. An entity shall therefore deduct proceeds received from the sale of items produced on the testing activity from the cost of an asset, even if the proceeds received exceed costs of testing.

Items produced before the asset becomes ready for use and sold after the asset becomes ready for use

B3. An entity may sell items produced when testing a property, plant and equipment asset during a reporting period subsequent to the one in which the testing took place. An entity shall recognise the cost of producing the test items as part of the cost of the asset in the period in which the testing is undertaken. The entity shall deduct from the cost of the asset the proceeds received from the sale of those test items when that sale occurs, even if the sale is made after the asset becomes ready for use.

Illustrative Examples for [draft] IFRIC Interpretation X

Accounting for proceeds and costs of testing for property, plant and equipment

These examples accompany, but are not part of, [draft] IFRIC Interpretation X.

The objective of these examples is to illustrate how an entity should account for the proceeds and costs of testing for property, plant and equipment.

Example 1—proceeds received when the asset is operated at less than full capacity
On 1 April 20X1, Entity A started the construction of an item of machinery to produce widgets. On 1 September 20X1, Entity A started testing whether the machinery was functioning properly and produced 5 sample widgets. The cost of testing the machinery was CU 60[1], including the cost of materials used to produce the sample widgets. On 5 September 20X1, Entity A shipped the sample widgets to the customer, in order to receive the customer's approval. On 30 September 20X1, the customer notified Entity A that it was satisfied with the quality of the products and paid CU65 for the sample widgets. Management determined that the asset was functioning properly and in the location and condition necessary for it to be capable of operating in the manner intended on 1 October 20X1. This is because Entity A determined that the machinery achieved its intended technical and physical performance by producing products that satisfied the customer, which will be sold in the ordinary course of business. Through the testing, Entity A also noted that the machinery was capable of producing inventories, at the quantity level that enables the Entity A to sell the items in the ordinary course of business. Entity A therefore started to depreciate the asset from that date. In that year, there was a scarcity of the raw materials needed to produce the widgets. Consequently, the machinery was used to produce only 200 widgets per month, even though management had originally intended to produce at least 500 widgets per month. By 31

[1] In this [draft] Interpretation, currency amounts are denominated in 'currency units' (CU).

December 20X1, 600 widgets had been produced and sold to the customer in the ordinary course of business.

Entity A sold the 600 widgets produced for CU6,000. The cost of goods sold was CU6,300.

The proceeds received from sale of the test productions (CU65) were deducted from the cost of the machinery.

In the financial statements for the year ended 31 December 20X1, Entity A recorded revenue and cost of widgets of CU6,000 and CU6,300 respectively, in profit or loss.

Example 2—testing costs relate to inventories sold to the customer after the asset is ready for use
On 1 April 20X1, Entity B started construction of an item of machinery to produce widgets. On 1 September 20X1, Entity B started testing whether the machinery was functioning properly and produced 5 sample widgets. The cost of producing the sample widget was CU 60, and was included in the cost of the machinery. The test items were sent to internal quality assurance group for internal testing and were not shipped to customers. On 2 September 20X1, the internal quality assurance group reported that the sample products achieved required performance specifications. On 2 September, 20X1, Entity B started testing the throughput capability of the machinery. On 10 September, 20X1, Entity B noted that the machinery is capable of producing inventories at the quantity level that enables the Entity B to sell the items in the ordinary course of business, although it was less than full capacity intended by management. As a result of testing the throughput capabilities, Entity B produced 100 widgets. The cost of producing the test widget was CU 600, and was included in the cost of the machinery. Depreciation expense was not included in these test widgets. Management determined that the asset was functioning properly and in the location and condition necessary for it to be capable of operating in the manner intended on 10 September 20X1. This is because the Entity B determined that the machinery achieved technical and physical performance of the asset by producing products that satisfied the required performance specifications, which will be sold in the ordinary course of business. Entity B also noted that the machinery was capable of producing inventories, at the quantity level that enables the Entity B to sell the items in the ordinary course of business, as a result of testing throughput capabilities. Entity B therefore started to depreciate the asset from that date. On 11 September 20X1, Entity started producing 800 widgets for a cost of CU6,400. All of the production was completed by 31 December 20X1. Entity B recorded inventory of CU6,400 on the balance sheet as of 31 December 20X1. Entity B shipped the 800 widgets from inventory to customers on 6 January 20X2. Entity B also shipped the 100 widgets, produced during the test for throughput capabilities, to a customer on 7 January 20X2. On 15 January, Entity B received proceeds of CU1,000 from the customer for the 100 widget produced during the throughput test and deducted the proceeds

from the cost of the machinery.

Example 3—Proceeds received from sale of ore during construction of a mine
On 1 January 20X0, Entity C started construction of a mine. During the process of sinking one of the mine shafts, ore was extracted and sold to a customer. The proceeds of selling the ore and costs of producing the ore were recognised in profit or loss when it was extracted and sold. On 1 June 20X1, Entity C substantially completed the physical construction of the mine and started its testing process to assess whether the asset was functioning properly. The assessment on functioning properly was a purely technical assessment, on the basis of chemical testing of a mixture of small samples. The testing period lasted for six weeks until 15 July 20X1. On 15 July 20X1, Entity C finished the testing on technical and physical performance of the mine and the mine was determined to be capable of producing the output that meet the definition of inventory, at a quantity level that enables the Entity C to sell the items produced in the ordinary course of business, although the mine did not reach the designed throughput based on the optimal efficiency intended by the management. Between 1 June 20X1 and 15 July 20X1, Entity C produced ore and sold the ore on 1 November 20X1. The proceeds from selling the ore were deducted from the cost of the mine. Entity C started production on 15 July 20X1 and reached its optimal efficiency on 15 December 20X1. Proceeds received after 15 July 20X1 were recognised as revenue in profit or loss. On 15 July, Entity C started depreciating the asset.

Basis for Conclusions on [draft] IFRIC Interpretation X
Accounting for proceeds received before a property, plant and equipment asset is ready for use

This Basis for Conclusions accompanies, but is not part of, [draft] IFRIC Interpretation X.

Introduction

BC1 This Basis for Conclusions summarises the IFRS Interpretations Committee's ('the Interpretations Committee') considerations in reaching its consensus.

Background

BC2 When an entity constructs property, plant and equipment, directly attributable costs to bring the asset to the location and condition necessary for it to be capable of operating in the manner intended by management are included in the cost of that asset, in accordance with paragraph 16 of IAS 16 *Property, Plant and Equipment*. Paragraph 17 of IAS 16 presents examples of directly attributable costs. One of the examples is the cost of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment).

BC3 The Interpretations Committee received a request to clarify whether any excess of proceeds received when testing an asset, over the costs of that testing, should be recognised in profit or loss or as a deduction from the costs of the asset.

BC4 During its outreach, the Interpretations Committee noted that there is diversity in interpreting the meaning of 'testing' in paragraph 17(e) of IAS 16. Accordingly, the Interpretations Committee decided to provide clarification on the meaning of 'testing' in relation to the issue.

Scope

BC5 The issue submitted related to the accounting for any excess of proceeds received during the testing of a property, plant and equipment asset. The guidance in IAS 16 in relation to testing property, plant and equipment applies to the accounting for the costs of testing and the proceeds received from the sale of test items produced. Consequently, this [draft] Interpretation applies to both the costs of testing and the proceeds received from the sale of test items.

BC6 IAS 16 refers in paragraph 17(e) to 'testing whether the asset is functioning properly'. IAS 16 refers in paragraph 16(b) to 'bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management'.

BC7 During its outreach, the Interpretations Committee learnt that proceeds might be received from the sale of items produced from the asset before the asset is capable of operating in the manner intended by management; some of the items produced might relate to testing whether the asset is functioning properly but others might arise from other activities. Accordingly the Interpretations Committee decided that the [draft] Interpretation should provide guidance on the accounting for all proceeds received from the sale of goods produced from a property, plant and equipment asset before that asset is capable of operating in the manner intended by management.

Issues

BC8 The Interpretations Committee observed that the deduction of 'proceeds' from the cost of an asset is referred to in IAS 16 only in relation to 'testing' the asset in paragraph 17(e) of IAS 16. The Interpretations Committee noted that different views have emerged about how to interpret the meaning of 'testing' in paragraph 17(e) of IAS 16. Accordingly, the Interpretations Committee decided that the [draft] Interpretation should provide clarification of the meaning of 'testing' the asset. It thought that clarifying what is meant by testing would help to clarify which proceeds should be deducted from the cost of an asset.

BC9 One of the views on the meaning of testing that the Interpretations Committee observed is that the testing process continues until the asset operates as intended by management in all respects. Management may use a predetermined throughput/yield/capacity as a criterion to establish when to cease capitalising costs, regardless of the level of inventory produced or revenue earned in the ordinary course of business. In this view, when determining whether the asset is functioning properly and capable of operating in the manner intended by management, an entity might wait for an asset to achieve a specific level of proceeds, or operate at a designed throughput based on optimal efficiencies or achieve positive cash flow for a specified period. In support of this view, it is argued that:

(a) The criteria to determine whether an asset operates in the manner intended by management differ depending on the intention of management for the particular asset held by the entity.

(b) The current Standard allows 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) Achieving the throughput/yield/capacity intended by management 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.

BC10 A second view is that the testing activity referred to in paragraph 17(e) should be narrowly interpreted to mean only the activity necessary to assess the technical and physical performance of an asset, rather than the financial performance of the asset. This view also considers that the capitalisation of costs ceases when the asset produces output that meets the definition of inventory, at a quantity level that enables the entity to sell it 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) Paragraph 17(e) of IAS 16 states that testing is whether the asset is 'functioning properly' rather than 'operating' at a particular predetermined level.

(b) 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. If a property, plant and equipment asset produces an item 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, the cost incurred to produce the inventory should be recognised as the cost of the inventory. Accordingly, when a property, plant and equipment asset is capable of producing inventory, at a quantity level that enables the entity to sell the items produced in the ordinary course of business, the activity of the asset is no longer testing.

(c) In many industries, entities may start production before the property, plant and equipment asset 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 concern that, in the first view, differences in management intention on the level of throughput/yield/capacity could result in differences in the pattern of revenue recognition.

(d) This view 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, if the intended level of throughput/yield/capacity is set particularly high, which cannot be achieved in a short period of time, this could result in the testing period lasting for a long period of time, which could continue even after an entity has started selling products in the ordinary course of business. Accordingly, this view considers that a distinction should be made between the testing period necessary to test the capacity of the property, plant and equipment asset and continuous operations selling the products in the ordinary course of business.

(e) this [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 property, plant and equipment 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.

Consensus

Meaning of 'testing' in paragraph 17(e) of IAS 16

BC11 The consensus reflects the second view, described in paragraph BC10. In reaching consensus, the Interpretations Committee noted that:

(a) The second view appropriately reflects the intention of IAS 16, because assessing the technical and physical performance, rather than the financial performance, of an asset is consistent with the notion of assessing whether the asset is 'functioning properly' in paragraph 17(e) of IAS 16.

(b) If testing were to be extended to include the period over which the output from an asset is increased to optimal throughput levels and efficiencies, this would require a broad range of judgements to be applied in determining when the asset is ready for use and would depend upon management's intended level of financial performance. This assessment would therefore be dependent on management's intention, and not only on management's judgement.

BC12 The Interpretations Committee also noted that it is necessary to understand the boundary between IAS 16 and IAS 2. In particular, the Interpretations Committee considered the question of when an item that is produced from a property, plant and equipment asset should be considered to result from the testing of the asset, and when it should be considered to be the production of inventories.

BC13 Paragraph 17(e) of IAS 16 requires that the costs of testing are included in the cost of the property, plant and equipment 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.

BC14 The Interpretations Committee observed that paragraph 6 of IAS 2 states that inventories are assets held for sale in the ordinary course of business. Consequently, the Interpretations Committee concluded that when the items produced from a property, plant and equipment asset meet the definition of inventories, at a quantity level that enables the entity to sell the item in the ordinary course of business, they 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, the Interpretations Committee observed that two criteria must be met in order for the operation of a property, plant and equipment 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 to test 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 item in the ordinary course of business.

Recognition of proceeds and costs that arise before an asset is capable of operating in the manner intended by management

BC15 Paragraph 16(b) of IAS 16 requires that all costs that are directly attributable to bringing a property, plant and equipment asset to the location and condition necessary for it to be capable of operating in the manner intended by management must be capitalised as part of the cost of the asset. This includes the costs of testing whether the asset is functioning properly in accordance with paragraph 17(e) of IAS 16. This is because testing whether the asset is functioning properly is necessary for completion of the asset.

BC16 The Interpretations Committee observed that the proceeds received from the sale of items produced from a property, plant and equipment asset while testing whether that asset is functioning properly should be deducted from the cost of the asset. This is required by paragraph 17(e) of IAS 16. The Interpretations Committee thought that this is appropriate, because testing whether the asset is functioning properly would normally require the asset to produce its intended product. This production will therefore be a necessary part of the testing in these circumstances, the cost of which will include the cost of any necessary raw materials. Although these raw materials do not form part of the asset being constructed, their use is necessary to complete its construction. Where the test production is sold, the Interpretations Committee noted that deducting the sales proceeds from the cost of the testing is consistent with the objective of attributing only the net cost of testing to the cost of the property, plant and equipment asset. The Interpretations Committee observed that deducting from the cost of the asset the proceeds received from the sale of test production, even if the proceeds exceed the total cost of testing, would be consistent with this objective. This is because the testing activity is part of bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

BC17 The Interpretations Committee also observed that because the production of items that meet the definition of inventory, at a quantity level that enables the entity to sell it in the ordinary course of business, would not qualify as testing, it did not expect that the circumstances in which the proceeds received from the sale of test production exceed the cost of testing would occur frequently.

Items produced before the asset becomes ready for use and sold after the asset becomes ready for use

BC18 The Interpretations Committee considered a circumstance in which the testing of a property, plant and equipment asset occurs in one reporting period, but the sale of the items produced during testing occurs in the following period, and after the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management. The Interpretations Committee concluded that there was no reason to depart from the accounting requirements set out in paragraph 17(e) of IAS 16 because of either the timing of the entity's reporting period, or the speed at which the test items were sold relative to the completion of the asset. Accordingly the Interpretations Committee thought that in this circumstance, the costs of testing should be included in the cost of the asset when incurred, and the proceeds received from selling items produced during testing should be deducted from the cost of the asset when earned.

Disclosure

BC19 The Interpretations Committee was concerned that when proceeds in relation to the testing activities were to be deducted from the cost of the asset, users might not appreciate the significance of the transaction without disclosure of the amount of proceeds that had been deducted from the cost of the asset. Accordingly, the Interpretations Committee concluded that an entity should consider whether disclosure should be made of the amount credited to the asset, if it was significant in relation to a proper understanding of the cost of construction of the asset.

BC20 The Interpretations Committee noted that paragraph 73(e) of IAS 16 requires the disclosure of a reconciliation of the carrying amount of property, plant and equipment. The Interpretations Committee thought that the entity should consider whether the proceeds deducted from an asset in accordance with paragraph 17(e) of IAS 16 should be disclosed separately within that reconciliation.

Transition

BC21 The Interpretations Committee observed 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 their computations. Consequently, the Interpretations Committee decided 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.

First-time adopters

BC22 The Interpretations Committee 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 BC21. Consequently, the Interpretations Committee decided that those transition provisions should be available to first-time adopters.