IAS 16: Property, Plant and Equipment – Proceeds before Intended Use

Extract, IFRS® Discussion Group Report on the Meeting – December 15, 2021

In May 2020, the International Accounting Standards Board (IASB) amended IAS 16 *Property, Plant and Equipment* to prohibit an entity from deducting from the cost of property, plant and equipment (PP&E) amounts received from selling items produced while the company is preparing the asset for its intended use. Instead, the entity will recognize such sales proceeds and related cost in profit or loss.

The amendments also clarify the meaning of the term "testing" and specify that:

- the proceeds from selling items produced while preparing PP&E for its intended use would be recognized in profit or loss in accordance with the applicable IFRS Standards. For example, IFRS 15 *Revenue from Contracts with Customers* would apply to sales of items that are assessed as being outputs of the entity's ordinary activities;
- the cost of items sold would be measured in accordance with the measurement requirements of IAS 2 *Inventories*; and
- when proceeds and costs are recognized in profit or loss for the sale of items that are not part of the entity's ordinary activities, the amounts and line items in which they are recognized should be disclosed.

These amendments are effective for annual reporting periods beginning on or after January 1, 2022. An entity shall apply these amendments retrospectively, but only to items of PP&E made available for use from the beginning of the earliest period presented when first applying the amendments.

The Group considered various issues arising from applying these amendments in practice.

Issue 1: Which industries will the amendments affect?

Analysis

While the IASB highlighted in its Basis for Conclusions that the amendments are expected to affect mining and petrochemical entities, the scope of the amendments is not limited to these industries.

The amendments will affect any industry with an item of PP&E that takes a long time to prepare for its intended use. These industries may include capital-intensive industries and industries that require a government's approval before using the PP&E. For example, automotive original equipment manufacturers need to meet regulatory requirements for safety and compatibility and might generate pre-production sales. Therefore, entities outside the extractive and petrochemical industries should also consider how these amendments affect the financial reporting.

On the other hand, entities in the extractive industry should carefully assess whether their assets are within the scope of the amendments. The amendments do not apply to costs the entity incurs in

the exploration and evaluation (E&E) phase. Instead, the entity should follow IFRS 6 *Exploration for and Evaluation of Mineral Resources* to account for E&E expenditures. IFRS 6 requires E&E assets to be initially measured at cost but does not specify how an entity accounts for proceeds received during the E&E phase.

The amendments will apply to extractive entities during the development phase. Therefore, following the amendments, the entity should report the proceeds and costs from selling items in profit or loss during this phase.

The Group's Discussion

Group members agreed with the analysis.

The Group noted that, in addition to the extractive industry, the amendments may affect other capital-intensive sectors. These sectors include the semi-conductor and energy sectors, which includes wind turbines, transmission and distribution lines, hydroelectric-dams and nuclear reactors.

One Group member commented that the amendments can affect certain covenants, such as those based on earnings before interest, tax, depreciation, and amortization. Therefore, entities should assess the impact on their covenants when implementing the amendments.

Issue 2: When is an item of PP&E available for use?

Analysis

As the amendments address the accounting for proceeds and costs from selling any items produced *while preparing an item of PP&E for its intended use,* it is important to determine when an item of PP&E is available for use.

The amendment to paragraph 17(e) of IAS 16 clarified the term "testing" as "assessing whether the technical and physical performance of the asset is such that it is capable of being used in the production or supply of goods or services." While this clarification made evident that an asset that is not yet capable of production or supply of goods or services is *not* available for use, entities need to exercise judgment to determine when an asset *is* available for use.

The IASB included some indicators of when an item of PP&E is available for use in the Basis for Conclusions on the Exposure Draft "Property, Plant and Equipment— Proceeds before Intended Use". These indicators include:

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

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

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

In addition, the Group discussed the issue of what is meant by the phrase "to be capable of operating in the manner intended by management" in the context of ceasing capitalization and commencement of depreciation at its December 2014 meeting prior to the amendments to IAS 16.

Entities should provide sufficient financial statement disclosure of the significant judgments required to assess when an item of PP&E is available for use. These may include the judgments management make to distinguish when testing has been completed and when the output produced is part of ongoing production.

The Group's Discussion

Group members agreed with the analysis, noting that determining when an asset is available for use requires judgment and should be based on entity specific facts and circumstances. Some Group members observed that in the extractive industry, one area that requires judgment is whether a processing plant is ready for its intended use during a "ramp-up" period when the plant is being modified and its production is low compared to its designed capacity.

Furthermore, some Group members highlighted that the application of the amendments will be impacted by what "asset" the entity applies the amendments to, also known as the unit of account. If the entity sets the unit of account too high (i.e. groups several items or elements into the asset), the asset could have a long pre-production period. As a result, the amendments may have a greater impact on the accounting for proceeds received from selling items produced during the pre-production period.

Issue 3: How should entities allocate the costs of the items produced and sold while preparing the asset for its intended use?

Paragraph 20A of the amended IAS 16 requires entities to apply the measurement requirements of IAS 2 to the costs of items produced and sold while preparing an item of PP&E for its intended use. This new requirement can create challenges for entities in practice when allocating costs between the costs of items produced and the costs necessary to make the item of PP&E available for use.

Specifically, the Group discussed the following three challenges:

Additional judgments required

Analysis

Paragraph 12 of IAS 2 requires the costs of conversion of inventories to include both direct costs as well as a systematic allocation of fixed and variable overheads (i.e., indirect costs), including depreciation. Following the amended IAS 16, entities will need to allocate direct and indirect costs incurred during the period before an item of PP&E is available for use between the items sold and the PP&E being developed. However, the amendments do not specify any method of cost allocation. Therefore, judgment is required to determine a rational and consistent basis of allocation.

Paragraph 13 of IAS 2 requires the allocation of fixed overheads to be based on the normal capacity of the production facilities, with unallocated fixed overheads recognized as an expense when

incurred. Therefore, entities need to exercise judgment to determine what “normal capacity” is when allocating fixed overheads to the items produced and sold while preparing the PP&E for its intended use. Assessing the normal capacity may be difficult when the PP&E is not yet available for its intended use in the production process.

Paragraph 16 of IAS 2 requires certain costs be excluded from the cost of inventories. For example, abnormal amounts of wasted materials, labour or other production costs should be recognized as expenses when incurred. Determining abnormal costs could be challenging in the pre-production phase.

Capabilities of the costing system

Analysis

Considering the additional costing information required as indicated in the previous section, applying the amendments may require entities to upgrade their costing system to track costs and inputs in greater detail.

The costs and efforts required to upgrade information systems could be significant.

Consumption of the PP&E

Analysis

Entities should assess whether the consumption of PP&E in producing items was more than negligible during its construction or development. More than a negligible consumption may indicate that the PP&E is available for use.

In many industries, the consumption of an item of PP&E before it is available for use is expected to be negligible. However, this may not be the case for industries where the testing period can be long and such costs could be significant.

The Group’s Discussion

Group members agreed with the analysis.

In addition to the examples of costs included in the analysis, one Group member noted that borrowing costs also need to be allocated between inventories and PP&E if both meet the definition of qualifying assets.

Several Group members observed that some entities may find the process of tracking costs such as direct labour costs between the items sold and the PP&E being developed challenging and costly. One Group member thought that if these costs are not material to the entity’s financial statements, the entity may consider developing a process to reasonably estimate the allocation between inventories and the PP&E instead of incurring significant costs to upgrade its financial systems.

One Group member commented that paragraph 14 of IAS 2 specifies cost allocation requirements that apply in situations with joint products. However, this paragraph suggests allocating costs based

on the relative sales value of products sold. This presents challenges when allocating between inventory and PP&E since PP&E will not be sold and fair value may not be easily determinable.

Given the significant judgment required to allocate the costs of the items produced and sold while preparing the asset for its intended use, Group members highlighted the need for sufficient and transparent disclosures on the judgments that have the most significant effect on the amounts recognized in the financial statements.

Issue 4: What are some practical considerations when applying the amendments?

Analysis

When implementing the amendments to IAS 16, an entity should:

(a) identify the items of PP&E that will be impacted by the amendments and that became available for use during the earliest period that is presented when first applying the amendments;

(b) apply judgment to identify, distinguish and allocate the appropriate costs to the items produced while preparing the affected items of PP&E for intended use; and

(c) assess whether its current costing systems can track any additional cost inputs that are required for appropriate cost allocation.

Furthermore, in accordance with paragraph 30 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, when the entity has not applied the amendments prior to their effective date, it shall disclose:

(a) this fact; and

(b) known or reasonably estimable information relevant to assessing the possible impact that application of the amendments will have on the entity's financial statements in the period of initial application.

The Group's Discussion

Group members agreed with the analysis.

Overall, the Group's discussion raises awareness of some application issues arising from the amendments to IAS 16. No further action was recommended to the AcSB.