

IAS 16: Capitalization of Costs

Extract, IFRS Discussion Group Report on Meeting – November 29, 2016

The Group discussed how to best move forward with raising the issue of when an asset is capable of operating in the manner intended by management ([IAS 16: Capitalization of Costs](#))¹ in light of recent international discussions.

At its October 2016 meeting, the IASB agreed with the IFRS Interpretations Committee's recommendation and tentatively decided to propose amendments to IAS 16 *Property, Plant and Equipment*. The amendments would prohibit the deduction of proceeds from selling items produced from the cost of property, plant and equipment (PPE) before it is capable of operating as intended by management. [IASB staff agenda paper 12C](#) summarized the IFRS Interpretations Committee's considerations and recommendations over the various meetings it had on the submitter's issue. This summary refers to the Group's issue of clarifying when an asset is available for use because at one point in time, the IFRS Interpretations Committee was considering whether to address this matter as well (refer to paragraphs 32 to 39 in the IASB staff agenda paper). However, clarifying when an item of PPE is available for use was determined to be beyond the scope of the question submitted.

The IASB staff agenda paper also noted that the IFRS Interpretations Committee had concluded that, "in assessing whether PPE is functioning properly, an entity assesses the technical and physical performance of PPE."

Although the issue of when an asset is available for use is not being addressed, the IASB staff agenda paper had suggested some possible indicators that might indicate that PPE is in the location and condition necessary for it to be capable of operating in the manner intended by management. Those indicators, as described in paragraph 37 of the IASB staff agenda paper, are as follows:

- (a) The physical construction of the PPE is complete (as discussed in paragraph 23 of IAS 23 *Borrowing Costs*).
- (b) The testing of the technical and physical performance of the asset is complete.
- (c) The PPE is capable of producing items that can be sold in the ordinary course of business (ie the PPE is capable of producing inventory as defined in IAS 2 *Inventories*). Similarly to the meaning of testing discussed earlier in this paper, this assessment would focus on the technical and physical performance of the PPE, and not the financial performance of that PPE."

The IASB staff agenda paper indicated that "including these indicators would not remove the need to apply judgement – an entity ultimately would still need to determine when the property, plant and equipment is capable of operating in the manner intended."

¹ After the Group's discussion in December 2014, the Group had a follow-up discussion in [May 2016](#).

Question 1: Would including indicators in IAS 16, such as those above, help clarify the issue of when an asset is capable of operating as intended by management?

The Group's Discussion

Some Group members thought additional guidance, such as including indicators in IAS 16 to clarify when an asset is capable of operating as intended by management, would be helpful to achieve a greater degree of consistency in practice. However, since this determination involves significant judgment by management, diversity would be reduced rather than eliminated.

The Group members observed that although additional guidance would be helpful, the issues relating to the accounting for the proceeds from selling items produced before the asset is available for use would still exist. With respect to the forthcoming proposals to amend IAS 16, the Group members noted that these proposals would not change how an entity determines when an asset is capable of operating in the manner intended by management. However, a few Group members thought the financial results produced under these proposals might bring further visibility to the issue if significant amounts of revenue are being recognized in profit or loss during the pre-production stage.

Group members also noted that another significant issue with the forthcoming proposals is how to allocate the costs associated with the revenue generated before the asset is available for use. For some mining entities, depreciation expense is one of the single largest costs. If the cost allocation issue is not properly addressed, profit margins may be distorted during the pre-production stage.

Another Group member thought there would be significant diversity in how preparers allocate costs to the associated revenue. The existing guidance in IAS 2 or IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* is not sufficient to address the cost allocation issue. For example, a preparer would struggle to apply the concepts of abnormal and normal costs for inventory in a pre-production phase.

One Group member also noted that IFRS 6 *Exploration for and Evaluation of Mineral Resources* may also need to be amended to reflect this potential amendment to IAS 16.

Question 2: Which one of the following options do Group members recommend the AcSB take as a next step in clarifying when an asset is capable of operating as intended by management?

Option 1 – Raise the issue when the narrow-scope amendments to IAS 16 are published for stakeholder comment.

Option 2 – Develop a separate submission to the IFRS Interpretations Committee proposing a possible solution.

Option 3 – Not raise the issue in light of the international discussions.

The Group's Discussion

The Group agreed with the staff's recommendation to raise the issue of clarifying when an asset is capable of operating in the manner intended by management when the narrow-scope amendments to IAS 16 are published for stakeholder comment (option 1). The Group acknowledged that there is doubt

on whether this issue will be addressed given the IFRS Interpretations Committee had attempted to do so during its deliberations. However, the Group sees this issue to be more fundamental than addressing where in the financial statements to recognize the revenue from selling items before an asset is ready for use. Furthermore, in light of the forthcoming proposals to prohibit the deduction of proceeds from the cost of PPE, the cost allocation issue is another fundamental matter that should be addressed.

(For a full understanding of the discussions and views expressed, listen to the [audio clip](#)).