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International Accounting Standards Board
30 Cannon Street
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19 October 2017

Dear Board members,

Invitation to comment – Exposure Draft ED/2017/4 – *Property, Plant and Equipment – Proceeds before Intended Use*

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on Exposure Draft ED/2017/4 – *Property, Plant and Equipment – Proceeds from Intended Use* to the International Accounting Standards Board (IASB or Board).

We generally support the Board's objective of reducing diversity in the treatment of all proceeds from the sale of items produced before an asset is ready for its intended use by requiring them to be recognised in revenue. However, we are concerned that the proposed amendment fails to address the resulting more significant issues of: a) the allocation of costs; and b) determining when an asset is ready for its intended use.

Cost allocation: The proposed amendment provides clear guidance on how to treat this type of revenue and reduces diversity. However, we are concerned that not providing guidance on the allocation of costs between property, plant and equipment (PP&E), inventory and profit or loss could lead to arbitrary determination of profit and will not necessarily improve financial reporting. In particular, without cost allocation guidance, the proposed amendment could result in artificially high reported margins on this type of sale as the cost of sales would not ordinarily include any depreciation of the underlying asset. Also, it will not necessarily provide users with a clear picture of the actual cost of an item of property, plant and equipment given the ongoing diversity in how costs are allocated. If the provision of additional guidance is not something the Board wants to entertain, specific disclosures may be needed in order to meet the objectives of providing users with a clear picture of total revenue and also of the actual cost of PP&E.

When an asset is ready for use: We note that the practice for making this determination varies significantly between industries and countries and can exacerbate the accounting concerns about the treatment of proceeds before an asset is ready for its intended use. While we understand the Board's rationale for deciding not to clarify this issue, we believe it is of sufficient importance to warrant a broader project. However, addressing the issue alone is not likely to eliminate the cost allocation issue. Therefore, whether or not the Board addresses the issue of when an asset is ready for its intended use, we believe the Board should address the issue of how to allocate costs.

Given these difficulties, we believe, most importantly, that the Board should address cost attribution as the proposed amendment in its current form is unlikely to lead to better financial reporting.

Ernst & Young Global Limited is a company limited by guarantee registered in England and Wales No. 4328808.

Our responses to the specific questions in the ED are provided in the Appendix.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas at the above address or on +44 [0]20 7951 3152.

Yours faithfully

Ernst & Young Global Limited

Appendix

> The Board is proposing to amend IAS 16 to prohibit deducting from the cost of an item of property, plant and equipment any proceeds from selling items produced while bringing that asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Instead, an entity would recognise the proceeds from selling such items, and the costs of producing those items, in profit or loss.
>
> Do you agree with the Board's proposal? Why or why not? If not, what alternative would you propose, and why?

As noted above, we acknowledge the proposed amendment will provide clearer guidance which will help to reduce diversity in practice relating to the treatment of proceeds from selling items before an asset is ready for its intended use. However, it will not reduce what we consider to be the areas where greater diversity exists or will emerge, including: a) the allocation of costs between PP&E, inventory and profit or loss; and b) determining when an asset is ready for its intended use.

Allocation of costs

The proposed amendment states that the costs of producing items of inventory before an asset is ready for its intended use must be recognised in profit or loss in accordance with applicable standards, i.e., IAS 2 *Inventories* (IAS 2).

However, the ED does not provide any additional guidance on how to allocate costs between those that relate to:

- Costs of inventory which is produced and sold before an item of PP&E is available for its intended use
- Costs that relate to PP&E
- Costs that should be excluded from the cost of inventories, such as abnormal amounts of wasted materials or labour

The challenge for some industries, particularly for the extractives industries, is that an entity may be performing activities that involve construction of assets and generation of inventories at the same time, e.g., production, development and possibly even exploration and evaluation (E&E) (for those entities in the extractives industries). This is not dissimilar to the difficulties acknowledged in IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* [IFRIC 20.BC14].Therefore, the allocation of costs is a considerable undertaking.

While the IASB acknowledges an entity will have to apply judgement in identifying the costs relating to income generated before an asset is available for its intended use, the Basis for Conclusions indicates that, in the IASB's view, the proposed amendment will require little more judgement beyond that already required to be applied under current IFRS. However, when considering the allocation of costs to inventory produced before an asset is ready for its intended use, additional considerations do arise. While the ED does acknowledge this, as it notes such an approach would mean the cost of such inventories would exclude depreciation of PP&E used in the production process, it concludes that such consumption of PP&E is likely

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to be negligible. We do not necessarily agree with this conclusion. There are instances, particularly for some mining projects and unconventional oil and gas (e.g. shale) projects, where the time taken to bring an asset to its condition and location ready for intended use, can be considerable. Not including depreciation relating to the consumption of such assets could result in artificially high gross margins in relation to the sale of such inventory, while, in reality, an entity may be experiencing inefficiencies and/or costs in relation to the production of that inventory.

We do however acknowledge that there may be a relationship between the quantum of this type of revenue and the consumption of the related asset and determination and application by entities of when an asset is ready for its intended use.

Therefore, if revenue is to be recognised in profit or loss, the issue of cost allocation and determining the appropriate amount of cost to be allocated to such sales is essential to achieve the objectives of reduction of diversity and improved financial reporting. Currently, where entities do recognise such revenue in profit or loss, a range of accounting practices exist for determining the related cost of sales which have evolved from prior GAAPs or industry guidance (for example, the former UK Oil Industry Accounting Committee Statements of Recommended Accounting Practice (the OIAC SORP) and approaches commonly adopted by extractives companies under previous Australian GAAP).

In the absence of specific guidance on how to allocate costs, diversity would remain and further diversity will emerge in how entities determine the profit or loss impact from the sale of such inventory, which could lead to profit or loss distortion or misleading results.

Given the interaction of the recognition of revenue in profit or loss and the allocation of costs is significant, we believe that the Board should address concerns about cost attribution as the proposed amendment, in its current form, is unlikely to lead to better financial reporting.

Determining when an asset is ready for its intended use

We also note the other issue that arises is determining when an asset is ready for its intended use. This is a critical date as it impacts other aspects of accounting for such assets, such as when costs (including borrowing costs) should cease to be capitalised, when accounting for stripping costs changes (mining companies only), and when depreciation commences. We observe significant diversity in how such a date is determined.

While we understand the Board's rationale for deciding not to clarify when an item of PP&E is ready for its intended use, we believe that this issue is of sufficient importance to warrant a broader project. In this context, we note that practice for determining when an asset is ready for its intended use varies significantly between industries and countries, which exacerbates the accounting concerns about the treatment of proceeds before an asset is ready for its intended use. However, addressing this issue alone is not likely to eliminate the issue of how to allocate costs. As such, whether or not the Board addresses the issue of when an asset is ready for its intended use, we believe the Board should address the issue of how to allocate costs.

Other issues

Exploration and evaluation assets in the scope of IFRS 6

We note this proposed amendment only focuses on IAS 16. However, for extractives entities, it is entirely possible that revenue may be earned during the E&E stage of a mine or oil and gas project. For example, for mining entities, during the evaluation phase, i.e., when the technical feasibility and commercial viability of a mine are still being determined, an entity may 'trial mine' to determine which development method would be the most profitable and efficient in the circumstances, and which metallurgical process is the most efficient. Ore mined through trial mining may be processed and sold during the evaluation phase. Similarly, for oil and gas entities, onshore wells are frequently placed on long-term production test as part of the process of appraisal and formulation of a field development plan. Test production may be sold during this time.

The accounting for such E&E assets is governed by IFRS 6 rather than IAS 16. If the IASB is to proceed with the proposed amendment to IAS 16, it should make clear whether it considers similar requirements apply to revenue earned during the E&E phase. If so, the Board should also propose an amendment to IFRS 6.

Consequential amendment to IFRIC 20

The ED notes the following consequential amendments to IFRIC 20: "*During the development phase of the mine (before production begins), stripping costs are ~~usually capitalised as part of the depreciable cost of building, developing and constructing the mine~~ accounted for applying IAS 16 Property, Plant and Equipment. ~~Those capitalised~~ Capitalised costs are depreciated or amortised on a systematic basis, usually by using the units of production method, once production begins.*"

This amendment is incomplete as it only refers to IAS 16 whereas IFRIC 20 says a deferred stripping asset is classified as either tangible or intangible, depending on how the underlying mine asset is classified. Therefore, for completeness this consequential amendment should also refer to IAS 38.

Furthermore, the reason for making this change should be explained in the basis for conclusions to avoid confusion. It is our understanding that this consequential amendment was merely part of a process to tighten up the wording by removing terms such as "usually capitalised" rather than to indicate some type of change in accounting under IFRIC 20.