Issue 155/November 2019

IFRS Developments

Revenue earned before an asset is ready for its intended use

What you need to know

- At the June 2019 IASB meeting, the Board agreed to finalise amendments to IAS 16, incorporating modifications made to its June 2017 ED.
- The IASB will amend IAS 16 to prohibit entities from deducting from an item of PP&E, any proceeds from selling items produced before the asset is available for use, and to require an entity to identify and measure production costs in relation to the sold items by applying IAS 2.
- In October 2019, the Board also agreed to amend disclosure requirements where the items sold are not part of the entity's ordinary activities.
- The amendments will be effective from 1 January 2022, with early application permitted.
- In the interim, entities should continue to apply existing policies.

Highlights

In June 2019, the International Accounting Standards Board (the IASB or the Board) decided to finalise the amendments to IAS 16 *Property, Plant and Equipment*. The amendments will be based on those originally set out in the exposure draft (ED), *Property, Plant and Equipment – Proceeds before Intended Use*, issued in June 2017, with some modifications. They will prohibit entities from deducting from the cost of an item of property, plant and equipment (PP&E), any sales proceeds earned 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, such sales proceeds must be recognised in profit or loss.

In response to the feedback on the ED, the amendments will also:

- Require an entity to identify and measure the cost of items produced before an item of PP&E is available for use, applying the existing measurement requirements of IAS 2 *Inventories*
- Not have additional specific presentation and disclosure requirements in relation to the sale of items that are part of the entity's ordinary activities
- Require additional disclosures in relation to the sale of items that are not part of an entity's ordinary activities

In October 2019, the Board agreed the amendments should apply to reporting periods beginning on or after 1 January 2022, with earlier application permitted. In addition, entities will be required to apply the amendments retrospectively, but only to items of PP&E made available for use on or after the beginning of the earliest period presented in the financial statements.

Building a better working world

Background

During the process of bringing an asset to the location and condition necessary for it to be capable of operating in the manner intended by management, revenue may be earned by an entity. This is common in the mining and oil and gas sectors:

- **Mining**: There are a number of situations where ore may be extracted and sold prior to a mine being ready for its intended use. For example, during the evaluation phase of a mine, an entity may 'trial mine' to determine the most profitable and efficient method of development. Or, as part of the process of constructing a deep underground mine, the mining operation may extract some saleable 'product' during the construction of the mine.
- **Oil and gas**: 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.

Cost of an item of PP&E

IAS 16 requires that the cost of an item of PP&E includes any costs directly attributable to bringing that asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Specifically, one type of cost identified in IAS 16.17(e), is the cost of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while making the asset available for use.

The amendments to IAS 16 will prohibit the deduction of sales proceeds from the cost of an item of PP&E. Instead, an entity would recognise such sales proceeds, together with the costs of producing those items (production costs), in profit or loss, applying the applicable IFRS.

A number of respondents to the ED noted that clarifying the requirements for when an item of PP&E is available for use was necessary. This is because it was unclear whether the existing requirements in IAS 16, to cease recognition of costs in the carrying amount of PP&E when the item is capable of operating in the manner intended by management, represented technical or financial considerations. To address this concern, the amendments will clarify the meaning of the word 'testing' in IAS 16.17(e). Specifically, they will clarify that when assessing whether an item of PP&E is functioning properly, an entity assesses the technical and physical performance of the asset, and not its financial performance.

Cost allocation

The amendments to IAS 16 will require an entity to separately identify the production costs associated with selling volumes before an asset is ready for its intended use. An entity will be required to identify and measure production costs applying the measurement requirements in paragraphs 9–33 of IAS 2 *Inventories*. This amendment is intended to do the following: address concerns about the lack of clarity regarding how such costs would be measured; reduce the practical challenges associated with identification of costs; and reduce the need for judgement and consequential diversity in practice. The Board looked to other IFRSs that contain cost allocation requirements and concluded that the application of IAS 2 would be appropriate. This was on the basis that IAS 2 specifies cost allocation requirements that apply in situations similar to those that arise when items are produced before an item of PP&E is available for use. The requirements in IAS 2 set out a framework to identify production costs without being overly prescriptive and the Board was not aware of significant difficulties in applying the existing cost allocation requirements of IAS 2.

The Board also decided not to amend IFRS 6 *Exploration for and Evaluation of Mineral Resources* or IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* as a consequence of these amendments.

Presentation and disclosure

Some respondents to the ED questioned whether the recognition of such sales proceeds and production costs in profit or loss would provide useful information. This was because, in their view, such proceeds are not necessarily part of an entity's ordinary activities and may not be representative of sales (and related production costs) that will occur after the item of PP&E is available for use. Those respondents believe such sales proceeds may have had limited predictive value. Accordingly, suggestions were made for the Board to consider whether specific presentation or disclosure requirements are necessary to enable financial statement users to identify sales proceeds and production costs.

In response to the feedback, the Board considered existing IFRSs. As a result, it determined that, if an entity assesses and concludes that the sale of items produced before an asset is ready for use is an output of its ordinary activities, then the sales proceeds would be revenue within the scope of IFRS 15 *Revenue from Contracts with Customers* and the related production costs would be accounted for as inventory within scope of IAS 2.

The Board concluded it did not need to develop additional specific presentation or disclosure requirements to address such situations. However, for the sale of items that are not part of an entity's ordinary activities (and to which an entity does not apply IFRS 15 and IAS 2), the Board decided to require an entity to:

(i) Disclose separately the sale proceeds and related production costs recognised in profit or loss;

And

(ii) Specify the line item(s) in the statement of profit or loss and other comprehensive income that include(s) the sale proceeds and related production costs.

Transition and effective date

The effective date for the amendments will be reporting periods beginning on or after 1 January 2022, with earlier application permitted. The Board believes this date will provide entities with sufficient time to apply the amendments.

Entities will be required to apply the amendments retrospectively, but only to items of PP&E that are made available for use on or after the beginning of the earliest period presented in the financial statements in which an entity first applies the amendments. Consequently, the cumulative effect of initially applying the amendments will be recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) on this date.
In developing the transition requirements, the Board specifically considered the costs of implementing the amendments. This approach aims to reduce the burden on entities by limiting the number of items of PP&E that an entity is required to reassess, while achieving consistent application of the amendments for all periods presented.

How we see it

The nature and extent of feedback received from respondents on the original ED reflects the significance of the amendments to IAS 16.

The amendments have the potential to improve consistency in how revenue is recognised (i.e., all revenue will be recognised in profit or loss regardless of when that revenue is generated). In addition, the requirement to use the principles of IAS 2 to determine the costs associated with such proceeds will provide a consistent framework that aligns with what entities are already applying when determining the cost of inventory. However, the amendments may lead to different costs being associated with revenue recognised before an asset is ready for use. This is because there may be no depreciation to attribute to the cost of production, as depreciation of the associated assets may not have commenced.

The presentation and disclosure requirements and transition requirements will provide an appropriate balance between requiring additional information to aid readers of the financial statements, improving and facilitating consistency, while also being cognisant of the burden on preparers.

EYG No. 005598-19Gbl

ED None