Issue 128 / June 2017

IFRS Developments

Revenue earned before an asset is ready for its intended use

What you need to know

- The IFRS Interpretations Committee (IFRS IC) and the IASB observed that entities have applied diverse methods when accounting for revenue earned before an asset is ready for its intended use.
- The IASB has issued an ED to propose an amendment to IAS 16.
- The amendments will prohibit revenue generated before an asset is available for its intended use from being deducted from the cost of the related property, plant and equipment – instead such amounts will need to be recognised in profit or loss.
- Closing date for comments is 19 October 2017

Highlights

On 20 June 2017, the International Accounting Standards Board (IASB) issued exposure draft (ED) *Property, Plant and Equipment – Proceeds before Intended Use* (Proposed amendments to IAS 16).

The ED proposes to amend IAS 16 *Property, Plant and Equipment* (IAS 16) to prohibit deducting from the cost of an item of property, plant and equipment (PP&E), 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 (i.e., the point up until it is available for intended use). Instead, such proceeds would be recognised in profit or loss.

The effective date will be decided after exposure of the proposed amendments. The transitional provisions proposed are that an entity would apply these amendments retrospectively only to items of PP&E brought to the location and condition necessary for them to be capable of operating in the manner intended by management on or after the beginning of the earliest period presented in the financial statements in which the entity first applies the amendments.

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 issue 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 an asset being ready for its intended use. These include 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, e.g., sinking shafts to the depth where the main ore-bearing rock is located.

- **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.

In these and other examples, it is possible that the net proceeds from selling items produced while testing the plant under construction may exceed the cost of related testing. While IAS 16 contains a principle that revenue earned as part of the process of testing an asset will reduce the cost of the asset, the standard is not clear as to whether such excess proceeds should be recognised in profit or loss or as a deduction from the cost of the asset.

The IFRS Interpretations Committee (IFRS IC) received a request to clarify two specific aspects of IAS 16, including:

a) Whether the proceeds referred to in IAS 16 relate only to items produced from testing

b) Whether an entity deducts from the cost of an item of PP&E any proceeds that exceed the cost of testing

After exploring different approaches to the issue, the IFRS IC recommended, and the IASB agreed, to propose this amendment to IAS 16.

What's changing?

Recognition of revenue

If the proposed amendments become effective, any revenue generated from the sale of items produced by PP&E before it is ready for its intended use would be prohibited from being deducted from the cost of that item of PP&E. Instead, these sales proceeds would be required to be accounted for and disclosed in accordance with IFRS 15 *Revenue from Contracts with Customers* (IFRS 15) in profit or loss. It has been noted in the ED that such amendments will provide relevant information to users of financial statements by requiring entities to consistently recognise all sales as revenue in profit or loss when they occur, regardless of when those sales occurred.

The ED indicates that there would be no basis on which to conclude that inventories produced by the asset before it is available for its intended use would not be output from the entity's ordinary activities. Consequently, proceeds from selling inventories produced would represent revenue from contracts with customers in the scope of IFRS 15.

Allocation of costs

The proposed amendments state 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 has not provided 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 Basis for Conclusions to the ED indicates that, while the IASB observed that an entity would have to apply judgement in identifying the costs, the proposed amendments would require little more judgement beyond that already required to apply current IFRS standards when allocating costs incurred.

The ED also acknowledges that, while such an approach would mean that the cost of such inventories would exclude depreciation of PP&E used in the production process, any such consumption of PP&E before it is available for its intended use is likely to be negligible.

While the ED provides no specific guidance, to date, where revenue from such sales have been recognised in profit or loss, various approaches have been observed in practice, particularly in the extractive industries, to determine the amount to be included in profit or loss as cost of goods sold relating to these sales. These include:

- An amount of costs equivalent to the revenue recognised is charged to cost of sales while the remaining costs incurred are recognised as part of the cost of the asset. This approach results in a zero net margin on such pre-production sales. This approach is similar to the guidance that was provided in 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
- An amount of costs equivalent to the standard, or expected, cost of production is ascribed to the volumes produced, such as the weighted average cost per tonne/barrel based on actual results over a historical period, e.g., the last two or three years; or for new mines or fields, the expected cost per tonne/barrel as set out in the business, mine or field plan, producing a standard margin, while the remaining costs incurred are recognised as part of the cost of the asset
- None of the costs incurred in getting an asset ready for its intended use are recognised in cost of goods sold, instead only the incremental cost of processing the product are recognised in profit or loss when incurred

Disclosures

The IASB decided that additional disclosure requirements were not required because the existing requirements of relevant standards were sufficient. Instead, it considered that, if revenue and the cost of inventories produced before an item of PP&E is available for its intended use have a material effect on an entity's financial statements, the entity would apply the following standards' disclosure requirements:

- IFRS 15: these disclosures would be considered to determine if they are relevant. In particular, revenue from the sale of these pre-production inventories might be considered as a category of revenue when disclosing disaggregated revenue information
- IAS 2: the disclosures regarding the costs of producing inventories, e.g., the accounting policy, the carrying amount of inventories (if any) and the amount of inventories recognised as an expense, will be required

Effective date and transition

The effective date of the amendments has not yet been determined. This will be decided after exposure of the proposed amendments.

With respect to the transitional provisions, the ED proposes that the amendments be applied retrospectively only to items of PP&E brought to the location and condition necessary for them to be capable of operating in the manner intended by management on or after the beginning of the earliest period presented in the financial statements in which the entity first applies the amendments. The cumulative effect of initially applying the amendments would be presented as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the beginning of that earliest period presented.

For example, if the amendments were to be effective for annual reporting periods beginning on or after 1 January 2019 and the entity was required to provide one year of comparative information, this would mean that any development projects which had not yet reached the location and condition necessary to be capable of operating in the manner intended by management by 1 January 2018 would need to be restated.

How we see it

While the proposed amendments will provide consistency in how revenue earned from PP&E is recognised, i.e., all revenue will be recognised in profit or loss regardless of when that revenue is earned, it will not necessarily reduce diversity. This is due to the proposed amendments not specifying how the costs incurred before an asset is ready for its intended use should be allocated between: a) the asset; b) inventories produced; and c) costs that should be recognised in profit or loss immediately.

In addition, while the proposed amendments will lead to greater visibility of different revenue classes, should this revenue be so material that separate disclosures are required by IFRS 15, it will direct more attention to the date at which an asset is ready for its intended use, i.e., the commissioning date. 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.

Next steps

The comment period closes on 19 October 2017. We encourage stakeholders to provide feedback to the IASB on the proposed amendments.

EYG No. 03987-173Gbl

ED None