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Global Mindset, Asian Insights

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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

RESPONSE TO EXPOSURE DRAFT – PROPERTY, PLANT AND EQUIPMENT – PROCEEDS BEFORE INTENDED USE (PROPOSED AMENDMENTS TO IAS 16) ("ED")

ISCA sought views from its members on the above ED through a two-month public consultation and from the ISCA Financial Reporting Committee which includes experienced technical accounting professionals from large accounting firms.

We welcome and support IASB's efforts to address diversity in accounting for proceeds from the sale of items produced before an asset is ready for its intended use, by requiring the proceeds to be recognised as revenue and costs of producing such items in profit or loss.

However, we do not agree with the proposed amendments to IAS 16 and share many of the concerns expressed by one of the Board members, Mr Zhang, in the Alternative View section of the ED. In particular, we are concerned with the issues of allocation of costs and possibility of earnings manipulation.

<u>Allocation of costs</u>
The proposed paragraph 20A states that the costs of producing those items before an asset is ready for its intended use are to be recognised in profit or loss in accordance with applicable standards. However, no further guidance is provided on how to allocate the costs between (i) costs necessary to make the item of property, plant and equipment available for use, (ii) costs to bring inventories to their present location and condition, and (iii) costs that should be recognised in profit or loss (e.g. abnormal amounts of wasted materials).

In contrast to the Board's views that the proposed amendments would require little more judgement beyond that already required to apply IFRS Standards, we believe that a significant amount of judgement could be required for the allocation of costs.

BC8 has explained that the costs of wastage of materials and inefficient usage of labour during the testing phase should not be included in the cost of inventory and this is a well understood principle. However, to prevent any further diversity in practice, the proposed amendment should state a clearer principle that an entity shall capitalise such wastage of materials and inefficient usage of labour as cost of property, plant and equipment as these costs are necessarily incurred to prepare the property, plant and equipment for its intended use.

In addition, the-proposed amendment specifies that an entity shall exclude depreciation of the property, plant & equipment from the costs of inventories produced during the testing phase. The rationale for this is that any consumption of an item of property, plant and equipment before it is available for use is likely to be negligible (paragraph BC11).

In our view, it is not a logical principle to require income to be recognised from selling items produced during testing but not to require expense to be recognised from depreciation on the basis that the asset is not available for use but it is actually used to generate revenue. It would be more logical to state a principle that the cost of the inventory produced during testing shall normally include raw materials, labour and overheads and an entity may exclude depreciation if it is negligible. This principle does not presuppose that depreciation of property, plant and equipment would be a negligible production input during testing phase (to accommodate the possibility that in certain capital-intensive industries, the cost of production comprises high property, plant and equipment input relative to material and labour costs).

Furthermore, the exclusion of depreciation from the profit or loss would mean that the results reported by entities during the period before the asset is available for use would not be a true reflection of the entity's results during normal operations. This could mislead the users of the financial statements.

<u>Possibility of earnings manipulation</u>
Determining the point at which an asset is ready for its intended use is important as it is at this point that an entity stops accumulating costs in the carrying amount of the asset, and starts depreciating the asset. The determination of this point could be highly judgemental.

We are concerned that the proposed amendments could result in entities deliberately delaying the point when the asset is available for use, while at the same time, continuing to report artificially high gross margins from the sale of items produced from testing. This, again, would be misleading to the users of the financial statements.

We would like to urge the Board to reconsider the proposed amendments in view of the above.

Should you require any further clarification, please feel free to contact Ms Felicia Tay, Manager, Corporate Reporting & Ethics (CoRE), from ISCA via email at felicia.tay@isca.org.sg.

Yours faithfully,

Ju May LIM
Deputy Director
Corporate Reporting & Ethics (CoRE)