

The Chair

2 December 2013
ESMA/2013/1774

**Wayne Upton
Chairman of IFRS IC
Cannon Street 30
London EC4M 6XH
United Kingdom**

Agenda item request: Classification and measurement of ‘core inventories’

Dear Mr Upton,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to enhancing the protection of investors and promoting stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. ESMA contributes to the regulation of financial services firms with a pan-European reach, either through direct supervision or through the active co-ordination of national supervisory activity.

As a result of the review of financial statements carried out by national competent authorities and ESMA’s co-ordination activities, we have identified an issue related to the application of IAS 2 – *Inventories* and IAS 16 – *Property, Plant and Equipment*, which we would like to bring to the attention of the IFRS Interpretations Committee for further consideration.

A detailed description of the case is set out in the appendix to this letter.

We would be happy to further discuss this issue with you.

Yours sincerely,



Steven Maijoor
Chair
European Securities and Markets Authority

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1. As part of their monitoring and supervisory activities, ESMA and national enforcers have identified divergent application of IFRS requirements regarding classification and measurement of a specific category of material owned by an entity and stored in its own facilities. Henceforth in this letter this category of material is referred to as '*core inventories*'. Divergence exists whether in IFRS financial statements '*core inventories*' are considered inventories in accordance with IAS 2 or property, plant and equipment (PPE) in accordance with IAS 16.

Description of the issue

2. '*Core inventories*' can be found in a number of sectors such as the non-ferrous metals industry, petrochemicals and gas extraction, with the following common characteristics as mentioned in the accounting literature:
 - a) *Amount*: A minimum amount of material must be present at all times during the production process in order to permit
 - i. plants to start operating for the first time, and/or
 - ii. subsequent production to be maintained.
 - b) *Physical separation*: The minimum amount of material
 - i. is physically commingled with ordinary inventories on an ongoing basis (e.g., oil, water, or gas that is transported in pipelines, or primary materials contained in a chemical plant's piping system), and/or
 - ii. cannot physically be separated from other inventories (e.g., gas in a cavern required to maintain a certain pressure).
 - c) *Time of removal*: The required minimum amount of material can only be removed
 - i. when the production facilities are finally decommissioned,
 - ii. when the production facility is overhauled, or
 - iii. during the production process at considerable financial expense.
3. The following examples of '*core inventories*' are frequently given in the literature or can be found in practice:
 - a) *Cushion gas in a cavern*: The volume of gas contained in cavern storage facilities can be broken down into working gas and cushion gas. Cushion gas is needed to maintain the minimum storage pressure required for optimum additions to and withdrawals from storage. Within the cavern, the cushion gas also serves to ensure stability and maintain the minimum pressure in the storage facility; it remains in the caverns over the long term to guarantee their stability.

- b) *Oil pipeline*: A pipeline must be filled with oil before being used for the first time. This minimum quantity of oil can only be removed if the use of the pipeline is interrupted.
 - c) *Non-ferrous metal refinery*: The production-process in this industry is characterized by a production chain consisting of numerous different stages and facilities where different qualities and quantities of materials in different physical conditions and different purity grades permanently flow through the facilities. The production facility functions permanently and effectively cannot be interrupted. In order for the factory to function (at least function efficiently), a minimum level of certain materials has to be maintained at all times in the different stages of the production process.
4. The classification of ‘*core inventories*’ seems to be unambiguous in case materials are stored in PPE owned by a third party. In this case they are classified as inventories in accordance with IAS 2¹. However, ESMA observed divergent views in respect to the classification and measurement of ‘*core inventories*’ that are stored in facilities owned by an entity itself. In that case ‘*core inventories*’ are considered either as PPE in accordance with IAS 16 or as inventories in accordance with IAS 2 as presented below:

View 1 – Classification as inventories according to IAS 2

5. Proponents of view 1 argue that although a certain minimum quantity of material is always required to ensure the proper functioning of the production process, ‘*core inventories*’ should be treated as ordinary inventories which are ordinarily interchangeable with other items. This viewpoint is based on the fact that, despite the continued existence of a minimum amount, the ‘*core inventories*’ become physically commingled with the remaining raw materials, consumables and supplies (cushion gas) or are even interchangeable with them on an on-going basis (pipeline fill). Therefore, the unit of account used in classification is not the minimum amount of material as a whole but rather merely the smallest unit of the material concerned (ultimately individual atoms). If this viewpoint is followed, ‘*core inventories*’ must be classified as inventories since they represent materials that are consumed in the production process (paragraph 6(c) of IAS 2) and hence are used for less than one period (paragraph 6(b) of IAS 16).

View 1A - Use of FIFO or a weighted average cost formula

6. Consequently, ‘*core inventories*’ would have to be measured together with the other inventories using the first-in, first-out (FIFO) or weighted average cost formula in accordance with IAS 2, paragraph 25 and 27.

¹ See PwC, Financial reporting in the power and utilities industry, 2nd edition, 2011, p. 21 (and PwC, Financial reporting in the oil and gas industry, 2nd edition, p. 36): “[...] product owned by an entity that is stored in PPE owned by a third party continues to be classified as inventory. This includes, for example, all gas in a rented storage facility. It does not represent a component of the third party’s PPE or a component of PPE owned by the entity. Such product should therefore be measured at first-in, first-out (FIFO) or weighted-average cost.”

*View 1B - No step-up in value in the absence of an accounting transaction*²

7. Proponents of view 1B believe that irrespective of the fact that ‘*core inventories*’ are interchangeable with other items (ordinary inventories), these exchanges do not represent accounting transactions. Accordingly, ‘*core inventories*’ would have to be measured at the lower of cost and net realisable value for the entire term of the underlying tangible asset to which they belong³.
8. However, it could be argued that this view leads to results similar to those that would be obtained if the LIFO method or the “base stock method” were to be applied – methods that were both prohibited in the past⁴ because they bear little relationship to recent cost levels (paragraph BC 13 of IAS 2) and because of their lack of representational faithfulness of inventory flows (paragraph BC 19 of IAS 2). Conversely, it could be argued that paragraph BC 19 of IAS 2 makes it also clear that IAS 2 does not rule out specific inventory cost methods that reflect inventory flows that are similar to LIFO.

View 2 – Classification as PPE according to IAS 16⁵

9. The predominant view in accounting literature and the most commonly used accounting policy seems to be to classify ‘*core inventories*’ stored in PPE owned by an entity as PPE in accordance with IAS 16.
10. Proponents of this view argue that ‘*core inventories*’ do not meet the definition of inventories because these items are neither held for sale nor consumed in the production process (paragraph 6 of IAS 2) based on the assumption that the unit of account for ‘*core inventories*’ is the minimum amount of material as a whole. For them it is irrelevant that no physical distinction can be made between the materials belonging to the ‘*core inventories*’ and those belonging to the remaining inventories.
11. If ‘*core inventories*’ were to be reported as inventories and not as PPE, some argue that impairment losses would have to be recognised for them as these materials cannot be sold or consumed in the production process. Hence proponents of view 2 argue that such accounting treatment would ignore the fact that the relevant materials are absolutely necessary to ensure the operational availability of the associated PPE.
12. Instead, these items meet the definition of paragraph 16(b) of IAS 16, since they are needed to bring another item of PPE to the condition necessary for it to be capable of operating in the manner intended by management to the operation of a facility during more than one operating cycle. In addi-

² See Deloitte, iGAAP 2013, 6th edition, volume A, part 1, p. 755, example 2A: “Because an accounting transaction does not take place at the time of each swap of crude oil, no step-up in the value of inventories is recognized. The pipeline fill is measured at the lower of cost and net realizable value throughout the term of the pipeline’s operations in accordance with IAS 2:9.”

³ It has to be noted that in the accounting literature this view is outlined in an example of a pipeline operator that does not produce or distribute oil itself, but rather provides the use of its pipeline to buyers and sellers of oil.

⁴ The “base stock method” was eliminated from IAS 2 in the 1990s and the LIFO method is not allowed in IFRS since 2003.

⁵ See E&Y, International GAAP 2013, p. 1379, 1607; PwC, Financial reporting in the power and utilities industry, 2nd edition, 2011, p. 21, 22 (and PwC, Financial reporting in the oil and gas industry, 2nd edition, p. 36, 37).

tion, '*core inventories*' will not be recovered through sale, as this would lead to significant economic losses.

13. If '*core inventories*' are classified as PPE, these items will in most cases be an integral part of a facility and will have to be depreciated either as part of the PPE to which associated or separately if they are significant (paragraphs 43-46 of IAS 16). In accordance with paragraph 51 of IAS 16, the residual value of a component is reviewed at least at each financial year-end. Consequently, if the price of the materials increases (as was the case with non-ferrous metals from 2009 to 2011), no depreciation is charged and significant hidden reserves may arise. Even though such materials are then continually physically substituted in the course of the working process, or at least exchanged with ordinary inventories, their accounting value could remain unchanged. Therefore, it could be argued that this view (like View 1B) could lead to significant hidden reserves, which might obscure the financial position of the entity.

Request

14. ESMA seeks clarification whether '*core inventories*' stored in facilities owned by an entity itself are included in the scope of IAS 2 and/or IAS 16 based on the current IFRS requirements and what is the unit of account to be used as the basis for their classification (i.e., entire minimum amount of the materials which must be present in order for production and remains constant over time, or the smallest unit of the materials concerned, which are constantly turned over during the production process).
15. ESMA found that enforcers in several European jurisdictions have encountered divergent classification and accounting treatment of '*core inventories*'. Accordingly, ESMA kindly suggests that the IFRS Interpretations Committee considers clarifying the accounting requirements in this respect.