Property, plant & equipment (IAS-16)

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Objective & Scope

Objective:

The objective of IAS 16 is to prescribe the accounting treatment for property, plant & equipment. The principal issues are:

- ✓ the timing of recognition of asset
- ✓ the determination of their carrying amounts; and
- ✓ the depreciation charges and impairment losses to be recognized.

Scope:

IAS 16 applied to all Property, Plant & Equipment until and unless any other Standard requires or permits a different accounting treatment.

- ✓ Scoped out: Assets held for sale, agricultural biological assets, non-renewal natural resource rights and reserves.
- ✓ Includes investment property , if cost model applied.

Initial recognition and measurement

Definition:

IAS 16 defines Property, Plant & Equipment as “tangible items that:

a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

b) are expected to be used during more than one period.

Recognition criteria :

The cost of an item of Property, Plant & Equipment is recognised as an asset if, and only if:

a) it is probable that future economic benefits associated with the item will flow to the entity; and

b) the cost of the item can be measured reliably

Points to be noted:

- Recognise major components as separate PP&E assets and depreciate separately
- When major overhaul and replacement takes place, remove old component’s remaining undepreciated cost. Recognise new component as PP&E asset (gain/loss to income statement)

Initial recognition and measurement

Measurement at initial Recognition:

An item of Property, Plant & Equipment that qualifies for recognition as an asset shall be measured at its cost.

Need to know:

- What elements of cost are included?
- How to measure cost?

Cost is defined as "….the amount of cash or cash price equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction….".

- If asset is acquired on payment terms that are deferred beyond normal credit terms, the cost in this case is the discounted amount being the cash price equivalent. (interest may or may not be capitalized)

Initial recognition and measurement

<u>Element of cost</u> :

- Purchase price + (import duties + non-refundable taxes) – (Trade discounts + Rebates)
- Directly attributable costs
- Initial estimate of the cost of dismantling and removing the item and restoring the site in which it is located.

Costs that are not Costs of Property, Plant & Equipment:

- Costs of opening new facility;
- Costs of introducing new product or service;
- Costs of conducting business in new location or with new class of customer;
- Administration and other general overhead costs;
- Costs incurred in using or redeploying an item;
- Amounts related to certain incidental operations.

Initial recognition and measurement

Examples of Directly Attributable Costs:

- Cost of employee benefits.
- Cost of site preparation.
- Initial delivery and handling cost.
- Installation and assembly cost.
- Cost of testing after deducting the net proceeds from selling any items produced.
- Professional fees. (legal and stamp duty)

If self-constructed:

1. Apply same principles
2. Charge abnormal costs like general admin and overheads to P&L
3. Interest costs during construction may be capitalized: IAS 23
4. Government assistance may be reduced from cost: IAS 20

Practical

ABC & Co., is installing a new plant at its production facility. It has incurred these costs:

- Cost of the plant Rs. 250,000.
- Initial delivery and handling cost Rs. 20,000.
- Cost of site preparation Rs. 60,000.
- Consultants used to advice on the acquisition Rs. 70,000.
- Interest charges paid to supplier for deferred credit Rs. 20,000.
- Estimated dismantling cost to be incurred after 7 years Rs. 30,000.
- Operating losses before commercial production Rs. 40,000.

Find out the costs to be capitalized as per IAS-16?

Total Cost of PP&E =(250,000 + 20,000 + 60,000 + 70,000 + 30,000)
= Rs. 430,000.

Interest charges may be capitalized if permitted by IAS 23 Borrowing Cost.

Operating loss before commercial production can not be capitalized.

Initial recognition and measurement

<u>Exchange of assets</u>:

If non-monetary transaction, exception to fair value principle if:

- the exchange transaction has no commercial substance or
- Fair value of neither the asset received nor the asset given up can be reliably measured.

Transaction lacks commercial substance – i.e. transaction has no economic effect on the entity.

Commercial Substance exists if:

1. Configuration of Cash flows (amount, timing, risk) of new asset differ from those of old assets transferred (e.g. exchange a factory that is fully operational in exchange for a greenfield site on which it intends to construct a new factory)
2. After tax cash flows of part of business taking on new asset (entity specific value) have changed
3. Difference in 1 or 2 above is significant.

Practical

Entity A exchanges car X with a book value of Rs.13,000 (fair value of Rs.13,250) for cash of Rs.150 and a car Y which has a fair value of Rs.13,100.

Need to understand whether the above transaction lacks commercial substance.

The above transaction lacks commercial substance as the Entity's future cash flows (between use of new asset and old asset) are not expected to change as a result of the exchange, it is in the same position as it was before the transaction.

The entity recognises the assets received at the book value of car X. Therefore, it recognises cash of Rs.150 and car Y as PP&E with a carrying amount of Rs. 12,850.

Subsequent measurement

<u>Choice of two models:</u>

1. Cost model
2. Revaluation model

Separate decision for each class of PP&E assets. Examples of a class: land, office equipment, machinery, buildings, etc.

Cost Model (CM):

- PP&E are carried after acquisition at cost, less accumulated depreciation and accumulated impairment losses

Revaluation Model (RM):

- PP&E are carried after acquisition at fair value at date of revaluation, less any accumulated depreciation and impairment losses after revaluation.

Depreciation

- Systematic allocation of cost to profit or loss over its useful life.
- Each major component may have different depreciation policy
- Depreciable amount determined after deducting residual value.
- Depreciation period begins when PP&E is in place and ready to use as intended by management and continues even if not used or is retired from active use
- Depreciation period ends when PP&E is derecognized or classified as held for sale (IFRS 5)
- Reviewed at least at each balance sheet date:
  - ✓ Residual value.
  - ✓ Useful life. (consider capacity, wear and tear, technology changes, changes in product demand, contractual or legal limits)
  - ✓ Depreciation method based on pattern that asset's economic benefits are expected to be received: (SL, DB, or activity-based)
- Changes are changes in estimate, so adjust current and future periods only.

Revaluation model:

- Revalue regularly.
- Revalue all assets of the same class.
- Revaluation increases credited to:
  - Profit or loss to the extent they reverse previous revaluation decrease of that asset.
  - Otherwise, equity (revaluation surplus).
- Revaluation decreases debited to:
  - Equity to the extent of any revaluation surplus in equity related to that asset.
  - Otherwise, profit or loss.

Practical:

- ABC & Co., has an item of plant with an initial cost of Rs. 100,000. At the date of revaluation accumulated depreciation amounted to Rs. 55,000. The fair value of asset, by reference to transactions in similar assets, is assessed to be Rs. 65,000.
- Find out the entries to be passed?

Practical

<u>Method – I:</u>

Accumulated depreciation	Dr	55,000	
Asset Cost	Cr		55,000
Asset Cost	Dr	20,000	
Revaluation surplus	Cr		20,000

The net result is that the asset has a carrying amount of Rs. 65,000 (100,000 – 55,000 + 20,000).

<u>Method – II:</u>

Carrying amount (100,000 – 55,000) =	45,000
Fair value (revalued amount)	65,000
Surplus	20,000
% of surplus (20,000/ 45,000)	44.44%

Entries to be Made:

Asset (100,000 x 44.44%)	Dr	44,440		
Accumulated Depreciation (55,000 x 44.44%)			Cr	24,440
Surplus on Revaluation			Cr	20,000

Derecognition

- **Derecognition:**
  - On disposal, or
  - When no future benefits expected from use or disposal.
- **Difference between carrying amount and net disposal proceeds recognised as gain/loss in profit or loss.**
- **Gains not classified as revenue.**
- **Apply IAS 18 *Revenue* in determining date of disposal.**
- **Consideration receivable measured at fair value.**

Presentation & Disclosure

- Measurement basis
- Depreciation methods
- Useful lives or depreciation rates
- Gross carrying amount and accumulated depreciation at beginning and end of period
- Reconciliation at beginning and end of period showing:
- Comparative information required
- Existence and amounts of restrictions on title to assets.
- PPE pledged as securities for liabilities.
- Amount of expenditures on account for PPE in the course of construction.
- Commitments for acquisition of PPE.
- Compensation from third parties.

Presentation & Disclosure

Disclosure requirements for revalued assets:

- Date of revaluation.
- Whether independent valuer was used.
- Methods and significant assumptions applied in estimating fair values.
- Extent to which fair values were determined directly or estimated.
- Carrying amount of each class of revalued PPE as under the cost model.
- Revaluation surplus, including movement and any restrictions of distribution of balance to shareholders.

Thank You

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