

# Educational material on Ind AS 16, Property, Plant and Equipment



## This article aims to

- Summarise the guidance provided by the educational material on Ind AS 16 on key topics.



The Institute of Chartered Accountants of India (ICAI), on 14 August 2017, issued educational material on Ind AS 16, which summarises the key requirements in Ind AS 16 and accounting issues that are expected to arise while implementing Ind AS 16 in the form of Frequently Asked Questions (FAQs). Key clarifications provided in the FAQs on significant implementation issues are as follows:

## Recognition

- *Assets not considered to be material:* Ind AS 16 does not prescribe the unit of measure for recognition of assets, and entities need to exercise judgement when applying the recognition criteria to Property, Plant and Equipment (PPE). Accordingly, ICAI clarified that entities should determine whether an individual item is insignificant and may not be recognised as PPE based on a careful assessment of facts and circumstances including consideration of materiality. Consequently, individual assets below a certain threshold determined by management may not be recognised as PPE, or be fully depreciated in the year of acquisition, provided their cumulative aggregate cost for that category of asset is not material.
- *Capitalisation and depreciation of spares:* The ICAI clarified that machinery spares that are held for use in the production of goods and are expected to be used for more than one period meet the definition of PPE. Therefore, such spares should be capitalised as PPE, irrespective of whether they have been procured at the time of purchase of the equipment or subsequently. However, where spares are not expected to be used for more than one annual period, although they may be used in two financial years, they would not meet the criteria for capitalisation as PPE.
- *Expenses incurred for aesthetic purposes:* Tangible items purchased for aesthetic purposes (such as paintings and sculptures at entrance hall and conference rooms), are considered to be held for administrative purposes. Items held for administrative purposes qualify as PPE as per the definition in Ind AS 16. If these items are expected to be used during more than one period, then they should be capitalised as PPE.

The ICAI further clarified that where an entity holds a rare piece of art or antique paintings that are protected by legal or contractual rights such as copyrights (e.g. signature of painter), it should evaluate whether such items are tangible or intangible assets. Where it is probable that the future economic benefits are expected to be derived from the intangible element, such items may be capitalised and disclosed as a separate class of intangible asset.

- *Assets with an intangible element:* Where an entity procures tangible assets with an intangible element (e.g. procurement of technical know-how for designing and installation of a plant), it should exercise judgement to determine which element of the asset is more significant - the PPE or the intangible element. Where the intangible element is integral to the larger asset, it should be capitalised as PPE as a directly attributable cost of acquisition or construction of the asset. However, if the intangible part is a separate asset in its own right, it should be capitalised as an intangible asset.
- *Consumables used in the process of manufacture:* The ICAI analysed the classification of process chemicals or consumables used in the process of manufacturing, e.g. catalysts used to manufacture chemicals. It clarified that the classification of catalysts used in the process of manufacturing, as PPE or inventory, would depend on whether they facilitate the process of manufacture or are consumed in the process. Accordingly, following situations summarise the accounting:
  - Catalyst facilitates the manufacturing process: If a catalyst with a life (or charge) of more than one year facilitates the manufacturing process, such that it can be reused, then it is considered to increase the future economic benefits and output efficiency of the plant. It would accordingly be capitalised as PPE.
  - Catalyst is consumed in the manufacturing process: If a catalyst with a life (or charge) of more than one year is in the nature of a supply to be consumed in the production process, it is considered as a consumable. It would accordingly be classified as an inventory.

### Initial measurement

- *Expenditure incurred by an entity to obtain regulatory permission to set-up a factory:* The ICAI clarified that such expenses should be capitalised in the cost of the factory building if these are directly attributable to bringing the factory building to the location and condition necessary for use and if management considers it probable that the relevant permission will be granted. Else, these expenses should be charged to the statement of profit and loss and cannot be capitalised subsequently.
- *Expenses incurred for welfare of employees:* The ICAI considered a situation where an entity has incurred non-obligatory expenses to construct/develop a tangible asset, e.g. a school (over which it does not have ownership rights) close to its refinery. The school is available for use by its employees and the general public. The ICAI clarified that such expenditure would not be considered directly attributable to bringing the refinery to its working condition for its intended use. Therefore, the expense incurred on developing the school should not be capitalised as PPE.
- *Cancellation fees on contract:* Entities may pay penalties or cancellation fees for terminating a contract to procure PPE from one vendor, and instead procure it from another. The ICAI clarified that such penalties or cancellation fees are not directly attributable to bringing the asset to the location and condition necessary for it to be capable of operation in the manner intended by management. Hence, these costs should not be capitalised as PPE.
- *Acquisition of land with an existing building:* Ind AS 16 states that land and buildings are separable assets and are accounted for separately, even when they are acquired together. In this context, ICAI considered a scenario where an entity acquires land with an existing building, and intends to demolish the building after acquisition. The existing building would not be utilised for any of the entity's business activities. The ICAI clarified that in this situation, the entity should capitalise the amount paid for the building in the cost of the land (irrespective of the fact that the fair values of land and building are available separately).
- *Interruption in construction of building:* The ICAI clarified that when construction of a building is interrupted due to abnormal delays, such as protests by farmers for additional compensation for an indefinite period, then costs incurred during the period of interruption should not be capitalised. This is because the interruption is not in a nature of a temporary delay and not a necessary part of the process of bringing the asset to the location and condition necessary for its intended use.
- *Accounting for demurrage:* Demurrage generally represents an abnormal cost and hence, should not be included as an element of cost of PPE. The ICAI, therefore, clarified that demurrage incurred on account of a nationwide transporters strike, represented an abnormal cost, and should not be capitalised to determine the cost of imported PPE. However, incurrence of demurrage may sometimes represent a normal cost considering the specific facts and circumstances of the case.
- *Discounts and rebates on PPE:* Ind AS 16 requires trade discounts and rebates to be reduced from the cost of PPE. The ICAI has clarified that it does not matter whether such discounts or rebates are received from the vendor directly or indirectly through a broker. For example, commission passed on by a broker to induce an entity to purchase an item of PPE would be in the nature of trade discounts and rebates received by the entity, which is deducted from the cost of acquisition of the item.

## Component accounting

*Major periodic inspection and repairs:* Certain items of PPE may be required to undergo major periodic inspections and repairs, e.g. ships need to undergo dry docking at an interval of three years as per statute. The cost of major inspections and replacements of parts should be recognised in the carrying amount of the PPE if the recognition criteria are satisfied. In the example above, the entity should account for the dry docking cost as below:

- *Cost of replacing parts:* If the costs of replacing parts meets the recognition criteria in Ind AS 16, the entity should capitalise those parts in the carrying amount of the ship as a separate component and derecognise the replaced parts. These parts will be depreciated over their useful life, i.e. three years.
- *Major inspection costs:* Major inspection costs should also be recognised in the carrying amount of the ship and be depreciated over the period remaining until the next dry-docking.

## Revaluation

- *Revaluation on business combination:* Ind AS 103, *Business Combinations* requires an entity acquiring another entity to measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values. The ICAI clarified that the fair value measurement of assets acquired is just an initial recognition of the asset at cost by the acquirer and does not tantamount to adoption of a revaluation model for existing assets within the same class.
- *Revaluation of assets under finance lease:* The ICAI clarified that assets held under a finance

lease and owned assets of similar nature and use should be classified as one class of assets and revaluation principles would apply to the entire class of assets.

## Depreciation

- *Useful life of PPE:* The ICAI clarified that determination of useful life and residual value of PPE is a matter of judgement and may be decided on a case to case basis. If an entity has adequate internal technical expertise, it may be appropriate for it to rely on the judgement of internal experts. Such advice should be supported by adequate documentation including the criteria and assumptions involved in making the determination of useful lives and residual value.
- *Depreciation on spares:* Ind AS 16 states that depreciation of an asset begins when it is available for use, and does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. Accordingly, the ICAI clarified that depreciation on spares recognised as PPE should begin from the date of their purchase.

## Liquidated damages

- *Liquidated damages payable subsequent to commissioning of plant:* An entity may be entitled to receive liquidated damages for a construction contractor's failure to meet performance conditions in terms of the desired quality and level of output subsequent to commissioning of a plant. The ICAI clarified that such liquidated damages arise as a result of inefficiencies on the part of the contractor and are directly linked to performance parameters for the plant subsequent to commissioning of the plant.

Hence, these liquidated damages should not be deducted from the cost of the related PPE.

- Liquidated damages for construction delays by contractor: The treatment of liquidated damages received on delays in completion of construction by the contractor depends on the facts and circumstances:
  - Liquidated damages are directly identifiable with the project and mitigate extra project costs to be incurred by the entity would be capitalised as part of the cost of the asset.
  - Other liquidated damages should be recognised as income.

## Enabling assets

- The ICAI clarified that the construction cost of enabling assets e.g. railway siding, road and bridge constructed by an entity to facilitate construction of a main plant (e.g. refinery), should be considered as the cost of construction of the refinery. Accordingly, expenditure incurred on enabling assets should be allocated and capitalised as part of the PPE. Though the entity cannot restrict the access of others from using the enabling assets, the reason for capitalisation of these items is that they are incurred in order to get future economic benefits from the project as a whole. Therefore, the project as a whole can be considered as the unit of measure for the purpose of capitalisation of the expenditure on enabling assets.

