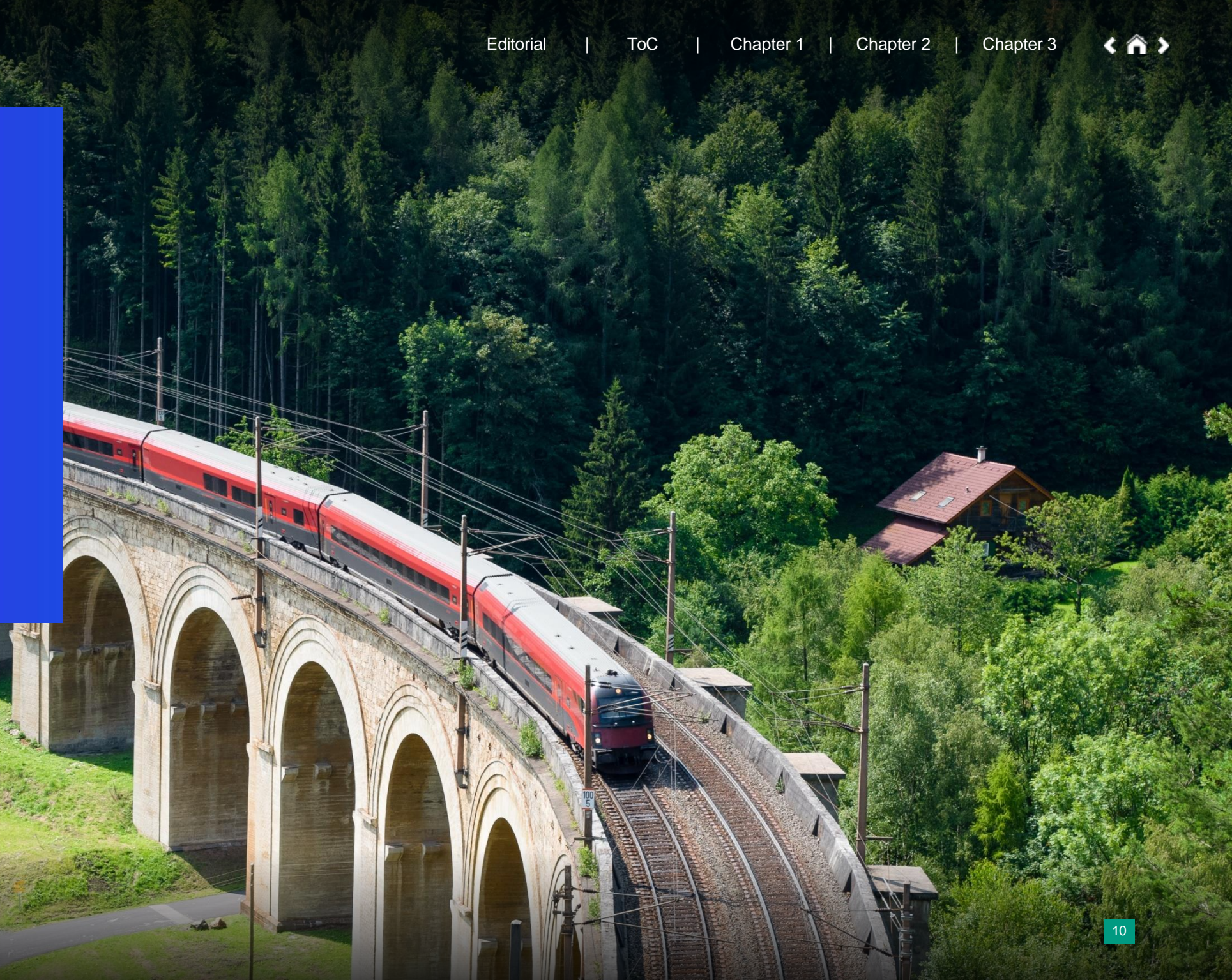


CHAPTER 2

Accounting for major spares

This article aims to:

- Discuss the accounting of spares that meet the definition of property, plant and equipment under Ind AS.



Ind AS 16, *Property, Plant and Equipment*, provides guidance on the accounting of Property, Plant and Equipment (PPE). Generally, for many companies, PPE is a significant item on the balance sheet. Spare parts are essential components of the PPE that ensure the smooth functioning of various equipment and machinery across industries. Proper accounting for PPE including spare parts is essential to ensure a true and fair view of the financial statements.

Ind AS 16 defines PPE as tangible items that:

- Are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes and
- Are expected to be used during more than one period.

Further, Ind AS 16 provides that spare parts, stand-by equipment and servicing equipment - e.g. tools and consumable lubricants are classified as PPE if they meet the definition, including the requirement to be used over more than one period. The principle of accounting that are followed for PPE are also being followed for spare parts under Ind AS framework.

Recognition criteria for PPE under Ind AS 16

The cost of an item of PPE or an intangible asset is required to be recognised as an asset if and only if it is probable that future economic benefits associated with the item flow to the entity and the cost of the item can be measured reliably. As specified above spare parts are recognised in accordance with Ind AS 16 when they meet the definition of PPE. Otherwise, such items are classified as inventory.



Accounting considerations for spare parts

The accounting treatment of spare parts is a critical aspect of financial reporting that requires careful consideration and adherence to guidance under Ind AS requirements. The accounting of spare parts has also been a subject matter of deliberation through various Expert Advisory Committees opinions (EACs) and issues under Ind AS Transition Facilitation Group (ITFG) bulletins issued by the Institute of Chartered Accountants of India (ICAI) in past.



Classification of spare parts

One of the primary considerations in spare parts accounting is their classification. Considering the guidance above, in a situation where an entity uses spare parts for an item of PPE, issues may arise on whether such spare parts should be recognised as inventory or capitalised as PPE and recognised as part of that equipment or whether depreciation should be computed separately for that spare part. In the cases, where spare parts meet the definition of PPE and satisfy the recognition criteria in Ind AS 16 then they, should be capitalised as PPE separately from the equipment with which it is intended to be used.





Initial recognition and measurement

The initial recognition and measurement of spare parts are crucial for accurate financial reporting. Spare parts should be recognised at cost, which includes the purchase price and any directly attributable costs necessary to bring the spare part to its present location and condition.



Depreciation

As per Ind AS 16, when an item of PPE comprises individual components for which different depreciation methods or rates are appropriate, each component is depreciated separately. Any item of PPE with finite useful life is depreciated/amortised on a systematic basis over its useful life. The depreciable amount of an asset is determined after deducting its residual value.

The depreciation of spare parts classified as PPE should be consistent with the depreciation policy for the related equipment or machinery. In this regard, ICAI in the past through its ITFG clarified that the depreciation on an item of spare part would begin when the asset is available for use i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management. The spare parts may be readily available for use and may be depreciated from the date of its purchase. In determining the useful life of the spare part, the life of the machine (in respect of which it could be used) could be one of the determining factors.

1. As per Ind AS 16, useful life is the period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from the asset by an entity.



Clarification through EAC

Though the accounting of spare parts and commencement of depreciation for such spare parts has been discussed by ICAI in past through ITFGs and EACs, many companies were still following the practice of capitalisation or commencement of depreciation of spare parts from the date of issue of such spare parts to the machinery which is not in line with guidance under Ind AS.

To reiterate the guidance related to accounting for spare parts, the ICAI has issued a EAC opinion recently on this topic. The EAC in its opinion pointed out that the major spares should be recognised as an item of PPE only when they meet the definition of PPE and satisfy the recognition criteria as per Ind AS 16. Further, once the spare parts are classified as PPE as per the above-mentioned principles, such items should follow the requirements of Ind AS 16 in all aspects. Accordingly, the spare parts should be capitalised, and their costs should be determined and depreciated as per the requirements of Ind AS 16.

With regard to depreciation, the EAC highlighted that the depreciable amount of an asset should be allocated on a systematic basis over its useful life¹. Further, considering guidance under Ind AS 16, the spare part should be capitalised and depreciated from the date it becomes available for use (i.e. when it is in the location and condition necessary for it to be capable of being operated in the manner intended by the management). This can be explained with the help of fact-pattern on the next page.





Scenario

In the scenario discussed in the EAC, the company operates in multiple production lines where similar machines and spares are being used between machines used in different lines of production having different residual useful lives. The company procures various spares to be used in any of the similar machines of different residual useful life whenever required. To ensure uninterrupted plant operation, inventory of such major spares are kept at central location (central store) in each plant for consumption at a later date as and when called for replacement. Considering that, the management was depreciating the major spares from the date of issue to the intended machine rather than date of purchase and receipt of spares at store.

Clarification: EAC considered the guidance under Ind AS 16 and clarified the following with regard to accounting for spare parts:



The intended use of spare part is to act as a stand-by for replacement of the original part in the plant and machinery in case of its damage/non-functioning/break-down and therefore, it is ready for its intended use on its purchase or acquisition though not on its actual use or replacement in the concerned plant and machinery. Such spare is in the location and condition for operating in the manner intended by management and is ready for its intended use of replacement. Accordingly, the spare part should be capitalised and depreciated from the date of its acquisition/purchase itself rather from the date when it is actually used/fitted.



As per the requirements of Ind AS 16, spare part should be depreciated considering its useful life, however, that useful life should be estimated in terms of its expected utility to the entity including both the periods of storage and use, considering factors such as, intended use, part to be replaced, historical data, expected obsolescence, etc.



With regard to accounting for installation or replacement cost of major spares that will be incurred at a later stage when the spare part is actually used for replacement in the concerned plant and machinery, it is provided that the depreciation is to be charged on the cost of spare part as determined as per the requirements of Ind AS 16. Such cost would not include installation and commissioning expenses to be incurred later during installation and commissioning of spares. Further, the company should determine accounting of such costs basis the materiality of such costs, and if these costs are not material, these may be recognised in the Statement of Profit and Loss.





Conclusion

In conclusion, accounting for major spares under Ind AS 16 is a critical aspect of financial reporting that ensures a true and fair view of the financial statements. Proper classification, recognition, and measurement of spare parts as PPE are essential. Spare parts that meet the definition and recognition criteria of PPE should be capitalised and depreciated in line with the related equipment or machinery. The guidance provided by the Institute of Chartered Accountants of India (ICAI) through various EACs and ITFG bulletins emphasises the importance of adhering to these principles. By following the requirements of Ind AS 16, companies can ensure accurate financial reporting and better management of their assets.

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