Educational Material on Indian Accounting Standard (Ind AS) 16 Property, Plant and Equipment

The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Foreword

Over the recent years, accounting has metamorphosed into a universal language of business to communicate financial information about an entity to the external world. In the era of globalised inter-connected economies embracing high quality globally acceptable accounting standards, Indian Accounting Standards (Ind AS) converged with IFRS is a business imperative for Indian economy today. ICAI is fully committed to its mission of enabling the nation with robust financial reporting framework of global standards. Ind AS will not only act as a gateway to global capital markets, but will also strengthen the economic co-operation. In this context, ICAI played a key role in recommending/formulating Indian Accounting Standards (Ind AS) substantially converged with IFRS standards. Today more than 125 countries require use of IFRS standards by all or most public entities. Transition to Ind AS, a comprehensive set of principle based standards, involves huge efforts. Hence, any transition of this size and nature comes with its own set of challenges. The ICAI has recognised challenges at an early stage and is making every possible effort to take these in stride, such as constitution of Ind AS Implementation Committee, way back in the year 2011.

In accordance with its Terms of Reference, this Committee is actively engaged in formulation of Educational Materials on Ind AS to provide guidance to the members and other stakeholders so as to enable them to implement these Standards in the same spirit in which these have been formulated.

Moving forward in this direction, the Committee has come out with Educational Material on Ind AS 16, *Property, Plant and Equipment*. The purpose of this Educational Material is to provide guidance by way of Frequently Asked Questions (FAQs) which explain the principles enunciated in the Standard. This publication will provide significant guidance to the stakeholders in how to account for the expenditures incurred on its property, plant and equipment and its disclosures.

I convey my heartfelt thanks to CA. Dhinal Ashvinbhai Shah, Chairman, CA. Sanjay Vasudeva, Vice Chairman and other members of the Committee including co-opted members and special invitees for their valuable support and cooperation. I am of the firm belief that this Educational Material will be useful publication for all who are getting ready for transition from existing

Accounting Standards to Ind AS and also for those who will audit the financial statements in accordance with Ind AS.

I am confident that all these efforts of Ind AS Implementation Committee will play a very significant role in smooth implementation of Ind AS in India.

New Delhi **CA. Nilesh S. Vikamsey**

July 10, 2017 ***President, ICAI***

Preface

Financial reporting framework in India has undergone a momentous transformation owing to the adoption of Ind AS, a robust set of standards based on IFRS Standards. Ind AS has become a reality now as the era of Implementation of Ind AS has already begun in the country with Phase I companies who have started to publish their financial statements prepared in accordance with Ind AS for financial year 2016-17. This paradigm shift has relatively filled the gaps of the financial reporting framework and has made it at par with high quality global standards of reporting.

The Institute of Chartered Accountants of India (ICAI) through its Ind AS Implementation Committee is making every possible effort to ensure that these Standards are implemented in the same spirit in which these have been formulated. For this purpose, the Committee is working to provide guidance to the members and other stakeholders by issuing Educational Materials on Ind AS, issuing timely clarifications on issues being faced by the members through Ind AS Transition Facilitation Group (ITFG) Clarification bulletins, addressing queries through Support-desk for implementation of Ind AS, conducting Certificate Course on Ind AS, developing e-learning modules on Ind AS, workshops, seminars, awareness programmes on Ind AS and series of webcasts on Ind AS etc.

I am glad that the Committee has brought out the Educational Material on Indian Accounting Standard (Ind AS) 16, *Property, Plant and Equipment*. This Standard brings out many new recognition and measurements concepts like component accounting, capitalisation of expenditure based on assessment of probability of future economic benefits associated with the item and not necessarily based on criteria of ownership, initial measurement to include asset dismantlement, removal and restoration costs, recognition of enabling assets such as safety and environment and major inspection costs as PPE, depreciation charge based on revalued amount under revaluation model.

The objective of Ind AS 16 is to prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such investment. This Educational Material contains summary of Ind AS 16 discussing the key requirements of the Standard and the Frequently Asked Questions (FAQs) covering the issues, which are expected to be encountered frequently while implementing this Standard.

I may mention that the views expressed in this publication are the views of the Ind AS Implementation Committee and are not necessarily the views of the Council of the Institute. The purpose of this publication is to provide guidance for implementing this Ind AS effectively by explaining the principles enunciated in the Standard with the help of examples. However, while applying Ind AS in a practical situation, reference should be made to the full text of the Standards.

I would like to convey my sincere gratitude to our Hon'ble President, CA. Nilesh Shivji Vikamsey and Vice-President, CA. Naveen N D Gupta for providing me this opportunity of bringing out implementation guidance on Ind AS in the form of Educational Materials. I am thankful to CA. Sanjeev Maheshwari and CA. Debashis Mitra for their support and cooperation. I wish to place on record my sincere appreciation to CA. Sudhir Soni, Co-convenor, CA. Veenit Surana, CA. Manan Lakhani, Dr. Avinash Chander and other members of the Study Group, for preparing the draft of this Educational Material. I would also like to thank all members, co-opted members, special invitees of the Ind AS Implementation Committee for their invaluable suggestions and contributions for finalising this publication.

I would like to thank CA. Geetanshu Bansal, Secretary, Ind AS Implementation Committee and CA. Prachi Jain, Executive Officer for their technical and administrative support in bringing out this publication. I would also like to thank CA. Vidhyadhar Kulkarni, Technical Consultant, ICAI, for his technical support and guidance.

I sincerely believe that this Educational Material will be of great help in understanding the provisions of Ind AS 16 and in the practical implementation of the same.

New Delhi
July 10, 2017

CA. Dhinal Ashvinbhai Shah
Chairman
Ind AS Implementation Committee

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I Ind AS 16 – Summary

Objective of Ind AS 16

One fundamental problem in financial reporting is how to account periodically for performance when many of the expenditures an entity incurs in the current period also contribute to future accounting periods. Expenditure on property, plant and equipment ('PP&E') is the best example of this difficulty.

The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such investment.

Scope

This Standard shall be applied in accounting for property, plant and equipment except when another Standard requires or permits a different accounting treatment.

All property, plant and equipment are within the scope of Ind AS 16 except as follows:

(a) property, plant and equipment classified as held for sale in accordance with Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations*.

(b) biological assets related to agricultural activity other than bearer plants (covered by Ind AS 41, *Agriculture*). This Standard applies to bearer plants but it does not apply to the produce on bearer plants.

(c) the recognition and measurement of exploration and evaluation assets (covered by Ind AS 106 *Exploration for and Evaluation of Mineral Resources*).

(d) mineral rights and mineral reserves such as oil, natural gas, and similar non-regenerative resources.

However, this Standard applies to property, plant and equipment used to develop or maintain the assets described in (b)–(d).

Recognition

The cost of an item of property, plant and equipment should be 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.

Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Ind AS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.

Ind AS 16 does not prescribe the unit of measure for recognition, i.e. what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value.

An entity should evaluate under the recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it.

Initial costs

Items of property, plant and equipment may be acquired for safety or environmental reasons. The acquisition of such property, plant and equipment, although not directly increasing the future economic benefits of any particular existing item of property, plant and equipment, may be necessary for an entity to obtain the future economic benefits from its other assets. Such items of property, plant and equipment qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

Subsequent costs

An entity does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in profit or loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of these expenditures is often described as for the 'repairs and maintenance' of the item of property, plant and equipment.

Parts of some items of property, plant and equipment may require replacement at regular intervals. Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a non recurring replacement. An entity recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard.

A condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.

Measurement at recognition

An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost.

Elements of cost

The cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Examples of directly attributable costs are:

(a) Costs of employee benefits arising directly from the construction or acquisition of the item of property, plant and equipment.

(b) Costs of site preparation.

(c) Initial delivery and handling costs.

(d) Installation and assembly costs.

(e) Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment) and

(f) Professional fees.

Examples of costs that are not costs of an item of property, plant and equipment are:

(a) Costs of opening a new facility.

(b) Costs of introducing a new product or service (including costs of advertising and promotional activities).

(c) Costs of conducting business in a new location or with a new class of customer (including costs of staff training).

(d) Administration and other general overhead costs.

Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item. For example, the following costs are not included in the carrying amount of an item of property, plant and equipment:

(a) Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;

(b) Initial operating losses, such as those incurred while demand for the item's output builds up; and

(c) Costs of relocating or reorganising part or all of an entity's operations.

Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the construction or development activities. For example, income may be earned through using a building site as a car park until construction starts. Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in profit or loss and included in their respective classifications of income and expense.

The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see Ind AS 2). Therefore, any internal profits are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset. Ind AS 23 *Borrowing Costs* establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.

Bearer plants are accounted for in the same way as self-constructed items of property, plant and equipment before they are in the location and condition necessary to be capable of operating in the manner intended by management.

Measurement of cost

The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is capitalised in accordance with Ind AS 23.

Acquisitions of property, plant and equipment in exchange for non-monetary assets or a combination of monetary and non-monetary assets are to be measured at fair value, unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired item is measured in this way even if an entity cannot immediately derecognise the asset given up. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

(b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and

(c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

Measurement after recognition

An entity shall choose either the cost model or the revaluation model as its accounting policy and should apply that policy to an entire class of property, plant and equipment.

Cost model

After recognition as an asset, an item of property, plant and equipment should be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

Revaluation model

After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

The frequency of revaluations depends upon the changes in fair values of the items of property, plant and equipment being revalued. Revaluations are to be made with sufficient regularity to ensure that the carrying amount does not differ materially from the fair value at the end of the reporting period. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is necessary. Some items of property, plant and equipment have significant and volatile changes in fair value and these should be revalued annually. If there are only insignificant movements it may only be necessary to perform valuations at three or five year intervals.

When an item of property, plant and equipment is revalued, the gross carrying amount and the accumulated depreciation at the date of the revaluation are treated in one of the following ways:

(a) The gross carrying amount is restated in a manner consistent with the revaluation of the carrying amount. The accumulated depreciation is the difference between the gross and the net carrying amounts. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the net carrying amount.

(b) The accumulated depreciation is eliminated against the gross carrying amount of the asset.

If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs should be revalued.

A class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. The following are examples of separate classes:

(a) land;

(b) land and buildings;

(c) machinery;

(d) ships;

(e) aircraft;

(f) motor vehicles;

(g) furniture and fixtures;

(h) office equipment; and

(i) bearer plants

If an asset's carrying amount is increased as a result of a revaluation, the increase should be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase should be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

If an asset's carrying amount is decreased as a result of a revaluation, the decrease should be recognised in profit or loss. However, the decrease should be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

The revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred directly to retained earnings when the asset is derecognised. This may involve transferring the whole of the surplus when the asset is retired or disposed of. However, some of the surplus may be transferred to retained earnings as the asset is used by an entity. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. Transfers from revaluation surplus to retained earnings are not made through profit or loss.

Depreciation

Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately.

An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease. The depreciation charge for each period should be recognised in profit or loss unless it is included in the carrying amount of another asset.

A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

The depreciation charge for each period shall be recognised in profit or loss unless it is included in the carrying amount of another asset.

The depreciation charge for a period is usually recognised in profit or loss. However, sometimes, the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the depreciation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories (see Ind AS 2). Similarly, depreciation of property, plant and equipment used for development activities may be included in the cost of an intangible asset recognised in accordance with Ind AS 38, *Intangible Assets*.

Depreciable amount and depreciation period

The depreciable amount of an asset should be allocated on a systematic basis over its useful life.

The residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with Ind AS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Depreciation of an asset begins when it 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 management. Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105 and the date that the asset is derecognised. Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

Land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.

If the cost of land includes the costs of site dismantlement, removal and restoration, that portion of the land asset is depreciated over the period of benefits obtained by incurring those costs. In some cases, the land itself may have a limited useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it.

Depreciation method

The depreciation method used should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

The depreciation method applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern. Such a change should be accounted for as a change in an accounting estimate in accordance with Ind AS 8.

A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method.

A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate. The revenue generated by an activity that includes the use of an asset generally reflects factors other than the consumption of the economic benefits of the asset.

Impairment

To determine whether an item of property, plant and equipment is impaired, an entity applies Ind AS 36 *Impairment of Assets*.

Compensation for impairment

Compensation from third parties for items of property, plant and equipment that were impaired, lost or given up should be included in profit or loss when the compensation becomes receivable.

Derecognition

The carrying amount of an item of property, plant and equipment should be derecognised:

(a) on disposal; or

(b) when no future economic benefits are expected from its use or disposal.

The gain or losses arising from derecognition of an item of property, plant and equipment should be included in profit or loss when the item is derecognised (unless Ind AS 17 requires otherwise on a sale and leaseback). Gains should not be classified as revenue.

The gain or loss arising from the derecognition of an item of property, plant and equipment should be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

The consideration receivable on disposal of an item of property, plant and equipment is recognised initially at its fair value. If payment for the item is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent is recognised as interest revenue in accordance with Ind AS 18 reflecting the effective yield on the receivable.

Disclosure

The financial statements should disclose, for each class of property, plant and equipment:

(a) the measurement bases used for determining the gross carrying amount;

(b) the depreciation methods used;

(c) the useful lives or the depreciation rates used;

(d) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and

(e) a reconciliation of the carrying amount at the beginning and end of the period showing:

   (i) additions;

   (ii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with Ind AS 105 and other disposals;

   (iii) acquisitions through business combinations;

(iv) increases or decreases resulting from revaluations and from impairment losses recognised or reversed in other comprehensive income in accordance with Ind AS 36;

(v) impairment losses recognised in profit or loss in accordance with Ind AS 36;

(vi) impairment losses reversed in profit or loss in accordance with Ind AS 36;

(vii) depreciation;

(viii) net exchange differences arising on the translation of the financial statements from the functional currency into a different presentation currency, including the translation of a foreign operation into the presentation currency of the reporting entity; and

(ix) other changes

The financial statements shall also disclose:

(a) the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;

(b) the amount of expenditures recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;

(c) the amount of contractual commitments for the acquisition of property, plant and equipment; and

(d) if it is not disclosed separately in the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in profit or loss.

If items of property, plant and equipment are stated at revalued amounts, the following should be disclosed:

(a) the effective date of the revaluation;

(b) whether an independent valuer was involved;

(c) for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model; and

(d) the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

Users of financial statements may also find the following information relevant to their needs:

(a) The carrying amount of temporarily idle property, plant and equipment;

(b) The gross carrying amount of any fully depreciated property, plant and equipment that is still in use;

(c) The carrying amount of property, plant and equipment retired from active use and not classified as held for sale in accordance with Ind AS 105; and

(d) When the cost model is used, the fair value of property, plant and equipment when this is materially different from the carrying amount.

Therefore, entities are encouraged to disclose these amounts.

Changes in Existing Decommissioning, Restoration and Similar Liabilities

Appendix A of Ind AS 16 also provides guidance on how to account for the changes in the measurement of any existing decommissioning, restoration or similar liability that has been recognised both as part of cost of PPE and liability in accordance with Ind AS 37.

Changes in the measurement may arise due to changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation, or a change in the discount rate.

Cost Model

If the related property, plant and equipment was measured in accordance with the cost model then changes in the liability shall be added to or deducted from the cost of the related asset in the current period. However, if adjustment results in a decrease in the cost of the asset then the amount deducted from the cost of the asset cannot exceed its carrying amount. If the amount exceeds the carrying amount, then such excess shall be recognised in profit or loss.

If the adjustment results in an addition to the cost of an asset, the entity shall consider whether the same is an indication for impairment. If it considers it to be so, then the asset shall be tested for impairment and accounted for in accordance with Ind AS 36.

Revaluation Model

If the related property, plant and Equipment was measured in accordance with the revaluation model, then, a decrease in the liability shall be recognised in profit or loss to the extent that it reverses a revaluation deficit on the asset that was previously recognised in profit or loss. Balance shall be recognised in other comprehensive income and increase the revaluation surplus within equity.

An increase in the liability shall be first adjusted to the extent of any credit balance existing in the revaluation surplus in respect of that asset and recognised in other comprehensive income. Balance shall be recognised in profit or loss.

If a decrease in the liability exceeds the carrying amount that would have been recognised had the asset been carried under the cost model, the excess should be recognised immediately in profit or loss.

A change in the liability indicates that the asset may have to be revalued so that it does not differ materially with its fair value at the end of the reporting period. Any such revaluation should be taken into account in determining the amounts to be recognised in profit or loss or in other comprehensive income as explained above. If a revaluation is necessary, all assets of that class should be revalued.

Changes in the revaluation surplus arising from a change in the liability shall be separately identified and disclosed in accordance with Ind AS 1.

The adjusted depreciable amount of the asset is depreciated over its useful life. Therefore, once the related asset has reached the end of its useful life, all subsequent changes in the liability should be recognised in profit or loss as they occur. This applies under both the cost model and the revaluation model.

The periodic unwinding of the discount shall be recognised in profit or loss as a finance cost as it occurs. Capitalisation under Ind AS 23 is not permitted.

Stripping Costs in the Production Phase of a Surface Mine

In surface mining operations, it may be necessary to remove mine waste materials (‘overburden’) to gain access to mineral ore deposits. This waste removal activity is known as ‘stripping’.

The stripping costs incurred during the development phase (before production phase) of the mine are capitalised as part of the depreciable cost of building, developing and constructing the mine. Those capitalised costs are depreciated or amortised on a systematic basis, usually by using the units of production method, once production begins.

The material removed during the stripping activity may not necessarily be a total waste. It may be a combination of ore and waste. It might also provide access to deeper levels of material that have a higher ratio of ore to waste. There can therefore be two benefits accruing to the entity from the stripping activity:

- usable ore that can be used to produce inventory and
- improved access to further quantities of material that will be mined in future periods.

Appendix B of Ind AS 16 provides guidance on when and how to account separately for these two benefits arising from the stripping activity.

Recognition of production stripping costs as an asset

To the extent the benefit is in the form of inventory produced, the entity shall account for the same in accordance with Ind AS 2, *Inventories.*

If the benefit is improved access to ore, the entity shall recognise these costs as a non-current asset, i.e Stripping Activity Asset, if all the following conditions are met:

(a) it is probable that the future economic benefit (improved access to the ore body) associated with the stripping activity will flow to the entity;

(b) the entity can identify the component of the ore body for which access has been improved; and

(c) the costs relating to the stripping activity associated with that component can be measured reliably.

The stripping activity asset shall be measured at cost and recognised as part of an existing asset and hence its classification as tangible or intangible will be same as that of the existing asset.

When the costs of the stripping activity asset and the inventory produced are not separately identifiable, the stripping costs shall be allocated using an allocation basis that is based on a relevant production measure such as cost of inventory produced compared with expected cost, volume of waste extracted compared with expected volume, for a given volume of ore production; and mineral content of the ore extracted compared with expected mineral content to be extracted, for a given quantity of ore produced.

Subsequent Measurement

After initial recognition, the stripping activity asset shall be carried at cost or revalued amount less depreciation/amortisation and any impairment losses.

The stripping activity asset shall be depreciated or amortised on a systematic basis, over the expected useful life of the identified component of the ore body that becomes more accessible as a result of the stripping activity. The units of production method shall be applied unless another method is more appropriate.

II Frequently Asked Questions

Recognition

Question 1

A manufacturing company has acquired agricultural land for setting up a factory building. For construction of the building, certain permissions are required from regulatory authorities. The company has to incur significant costs (non-refundable) for obtaining such permissions such as environmental clearance and change of land use, etc. Whether such cost can be capitalised? If yes, whether this can be capitalised as a cost of construction of the factory building?

Response

As per paragraph 7 of Ind AS 16, "the cost of an item of property, plant and equipment shall be 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."

Further, paragraph 10 of Ind AS 16, provides that an entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred.

In accordance with the above-mentioned paragraphs, for assessing whether costs incurred for obtaining permission should be capitalised, judgment is required, at the time when the expenditure is incurred, of whether it is probable that the relevant permission will be granted and as a result of which future economic benefits will flow to the entity.

In some cases, regulatory permission may be a formality, for example:

(i) the company regularly obtains such permission; or

(ii) has been told informally that the permission will be granted; or

(iii) as per the past experience of the company, it will be able to obtain such permission in a short span of time.

In such cases, there may be sufficient evidence that it is probable that future economic benefits will flow to the entity.

However, in other situations where consent from regulatory authority is not a formality for example, if the company has been trying to get permission for some time and still has no indication of whether it will be granted, it seems unlikely that the company can demonstrate access to future economic benefit.

Further paragraph 16 of Ind AS 16, *inter alia*, provides that "the cost of an item of property, plant and equipment comprises any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management."

In accordance with the above, in the given case since these costs are directly attributable for bringing the factory building to the location and condition necessary for it to be capable of operating in the manner intended by management and if the company anticipates that the grant of permission is probable, then the expenditure incurred for obtaining permission should be capitalised in the cost of factory building. If these costs do not meet the recognition criteria as envisaged in paragraph 7, then such costs should be charged as an expense in the Statement of profit and loss. Once expensed, if there is subsequently a change in circumstances, then these costs cannot be capitalised.

Question 2

ABC Ltd. is setting up a new refinery outside the city limits. In order to facilitate the construction of the refinery and its operations, ABC Ltd. is required to incur expenditure on the construction/development of railway siding, road and bridge. Though ABC Ltd. incurs (or contributes to) the expenditure on the construction/development, it will not have ownership rights on these items and they are also available for use to other entities and public at large. Whether ABC Ltd. can capitalise expenditure incurred on these items as property, plant and equipment (PPE)? If yes, how should these items be depreciated and presented in the financial statements of ABC Ltd.?

Response

Paragraph 7 of Ind AS 16 states that "the cost of an item of property, plant and equipment shall be 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."

Further paragraph 9 of Ind AS 16 provides that, "This Standard does not prescribe the unit of measure for recognition, i.e., what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value."

Paragraph 16 of Ind AS 16, *inter alia*, states that the cost of an item of property, plant and equipment comprise any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

In the given case, railway siding, road and bridge are required to facilitate the construction of the refinery and for its operations. Expenditure on these items is required to be incurred in order to get future economic benefits from the project as a whole which can be considered as the unit of measure for the purpose of capitalisation of the said expenditure even though the company cannot restrict the access of others for using the assets individually. It is apparent that the aforesaid expenditure is directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

In view of this, even though ABC Ltd. may not be able to recognise expenditure incurred on these assets as an individual item of property, plant and equipment in many cases (where it cannot restrict others from using the asset), expenditure incurred may be capitalised as a part of overall cost of the project. From this, it can be concluded that, in the extant case the expenditure incurred on these assets, i.e., railway siding, road and bridge, should be considered as the cost of constructing the refinery and accordingly, expenditure incurred on these items should be allocated and capitalised as part of the items of property, plant and equipment of the refinery.

Depreciation

As per paragraph 43 of Ind AS 16, each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

Further paragraph 45 provides that, a significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

In view of the above, if these assets have a useful life which is different from the useful life of the item of property, plant and equipment to which they relate, it should be depreciated separately. However, if these assets have a useful life and the depreciation method that are the same as the useful life and the depreciation method of the item of property, plant and equipment to which they relate, these assets may be grouped in determining the depreciation charge. Nevertheless, if it has been included in the cost of property, plant and equipment as a directly attributable cost, it will be depreciated over the useful lives of the said property, plant and equipment. The useful lives of these assets should not exceed that of the asset to which it relates.

Presentation

These assets should be presented within the class of asset to which they relate.

Question 3

Continuing the illustration in Question 2 above, ABC Ltd. under an understanding with local authorities also construct a school, which will be subsequently handed over to be managed by an independent trust. Though ABC Ltd. incurs expenditure on the construction/development of the school, it will not have ownership rights and the assets will also be available for use to the general public (however, preference will be given to employees of the Company). Whether ABC Ltd., can capitalise expenditure incurred as its property, plant and equipment?

Response

In the given case, if there is no obligation to construct the school and if ABC Ltd. will be able to construct the refinery without constructing the school, It cannot be considered as directly attributable to bringing the refinery to its working condition for the intended use as the incurrence of this expenditure is not necessary for construction or operations of the refinery.

Therefore, the expenditure incurred on construction of school should not be capitalised.

Question 4

A large manufacturing company expenses off items purchased below a certain threshold set by the management. Whether such a policy is permissible under Ind AS?

Response

As per Ind AS 16, "the cost of an item of property, plant and equipment should be recognised as an asset, if the recognition criteria mentioned in paragraph 7 of Ind AS 16 is met."

Further paragraph 9 of Ind AS 16 provides that, "this Standard does not prescribe the unit of measure for recognition, i.e., what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value."

However, while applying provisions of Indian Accounting Standards, materiality of items needs to be considered. With regard to materiality, paragraph 30 of *Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards* provides that "information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission of misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have to be useful".

Materiality needs to be determined under the specific facts and circumstances keeping in view as to how it affects the financial statements either individually or in the aggregate.

As per the "Guidance Note on Accounting for Depreciation in companies in the context of Schedule II to the Companies Act, 2013", issued by the ICAI, as the life of the asset is a matter of estimation, the materiality of impact of such charge should be considered with reference to the cost of asset. The size of the company will also be a factor to be considered for such policy. Accordingly, a company may have a policy to fully depreciate assets upto certain threshold limits considering materiality aspect in the year of acquisition.

In accordance with the above, deciding that an individual item is insignificant and the same may not be recognised as property, plant and equipment is a matter of professional judgment which requires careful assessment of facts and circumstances including qualitative aspects.

Accordingly, individual insignificant assets below a threshold determined by management may not be recognised as property, plant and equipment.

These may be expensed if their cumulative aggregate cost for that category of asset is not material.

Question 5

A Company produces fertilizers at various manufacturing units. The manufacturing units use various processes/technologies for manufacture of fertilizers. The Company has machinery spares (which are customised by the supplier as per the requirements of the company) and are expected to be used for more than one period. How should machinery spares be accounted for as per Ind AS?

Response

As per paragraph 8 of Ind AS 16, items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Ind AS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.

Paragraph 6 of Ind AS 16 provides that property, plant and equipment are 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.

In accordance with above, in the given case, the machinery spares are held for use in the production of goods and are expected to be used for more than one period. Hence, the same should be capitalised as property, plant and equipment in accordance with this Standard irrespective of whether procured at the time of purchase of the equipment or subsequently.

Question 6

The management of a Company has set an internal limit for capitalisation of spares to be Rs. 50,000 i.e., any item of spare having useful life of more than 1 year and value more than Rs. 50,000 would be capitalised by the Company.

Further, spares which are used collectively need to be capitalised, if the collective total of the same exceeds Rs. 50,000. Whether such spares should be capitalised from the date of its purchase or date of actual issue of that spare into use since such spares are procured in advance and kept in stores till the time they are issued for use?

How should 'expected to be used during more than one period' be interpreted. Whether a spare that has a life of less than one year but is being used in two financial year periods as per the date of issue, can be capitalised?

Response

Paragraph 8 of Ind AS 16 states that, "items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Standard when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory."

Further, paragraph 6 of Ind AS 16 provides that, property, plant and equipment are 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.

Paragraph 9 of Ind AS 16 states that, "this Standard does not prescribe the unit of measure for recognition, i.e., what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value".

The Standard does not distinguish between different types of spares. In the given case, the spares are not individually significant compared to the overall asset. The nature and purpose of such spares need to be carefully evaluated. If it is probable that future economic benefits associated with the item would flow to the company and cost of the item can be measured reliably then these items should be recognised as property, plant and equipment.

Further, paragraph 55 of Ind AS 16, *inter alia,* states that, depreciation of an asset begins when it 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 management. Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated.

Accordingly, depreciation on the spares recognised as item of property, plant and equipment shall begin from the date of its purchase.

It may also be noted that accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

The term 'more than one period' is not defined in Ind AS. Ordinarily, the accounting policies are determined for preparing and presenting financial statements on annual basis. Accordingly, the term 'period', should ordinarily be construed to be the annual period.

In the given case, spares that are not expected to be used during more than one annual period should not be capitalised as item of property, plant and equipment.

Question 7

Company A has exhibited certain rare and expensive paintings and sculptures for aesthetic purposes at entrance hall, conference rooms. The entity does not trade in these items in the ordinary course of business. How such items should be recognised in the financial statements of Company A?

Response

As per paragraph 6 of Ind AS 16, property, plant and equipment are 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.

In the given case, Company A is not in the business of trading in paintings and sculptures but is holding them for aesthetic purpose which is considered to be administrative in nature. Assuming these paintings and sculptures are expected to be used during more than one period, the same should be capitalised as an item of property, plant and equipment.

However, there may be situations wherein an entity holds rare piece of art or antique paintings that are protected by legal or contractual rights such as copyrights (e.g. signature of the painter). Further, it may be possible that their value appreciates with time. An entity needs to evaluate that whether such artistic related items are tangible or intangible assets. It is probable that the future economic benefits are expected to be derived from the intangible element and hence such rare piece of art may therefore be artistic related intangible assets. Such items should be disclosed as a separate class of intangible asset.

Subsequent costs

Question 8

A section of a mall is renovated by constructing a food court and gaming zone so as to increase the footfall in the mall. The food court and gaming zone are expected to result in a significant increase in sales for the shops and outlets of the mall. Whether this cost of construction of food court and gaming zone should be capitalised as property, plant and equipment or expensed off in the Statement of Profit and Loss?

Response

Paragraph 7 of Ind AS 16 requires that the cost of an item of property, plant and equipment shall be 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.

Further as per paragraph 10 of Ind AS 16, an entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it.

In view of the above, since it is probable that the construction of food court and gaming zone will result into flow of future economic benefits to the entity in the form of increase in sales and the cost of construction can be measured reliably, accordingly, the subsequent cost of construction of food court and gaming zone should be capitalised in the cost of mall as an item of property, plant and equipment.

Question 9

An entity is engaged in refining of petroleum products. It has a captive power plant with Gas Turbine Generators. Critical parts of generators are exposed all the time to very high temperatures leading to fracture of these parts. As a result, various components of generators need regular overhauling in line with scheduled cycle of number of hours of operations prescribed as per manufacturers' manual. At the time of such overhauling, these parts are required to be replaced. Certain servicing charges are also incurred at the time of overhaul. How should such costs incurred on replacement of critical parts be accounted for under Ind AS?

Response

Paragraph 13 of Ind AS 16 provides that, parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe. Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a non-recurring replacement. Under the recognition principle in paragraph 7, an entity recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of Ind AS 16.

Further, paragraph 7 of Ind AS 16 requires that the cost of an item of property, plant and equipment shall be 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.

In the given case, since, the critical parts of the generator are required to be replaced at regular intervals to run the gas turbine generator to generate the power, accordingly, it implies that future economic benefits associated with the replaced item will flow to the entity.

Assuming the cost of these items can be measured reliably, the company should recognise the cost of replacing these parts in the carrying amount of generators. The carrying amount of the replaced part should be derecognised as per derecognition principles of Ind AS 16. Further, the day to day servicing charges incurred are expensed to the statement of profit and loss. However, servicing charges which incurred at the time of replacing the part or in connection with replacing the part should be capitalised (i.e., where these charges do not relate to ongoing day to day services, and which are directly attributable and meet the definition of property, plant and equipment).

Measurement at recognition

Question 10

On 1 April 2015, X Limited began the construction of a new factory. Costs relating to the factory, incurred in the year ended 31 March 2016, are as follows:

Particulars	Amount (Rs.in thousands)
Cost of dismantling existing structures on the site (demolition cost)	500
Material consumed to construct the factory	6,000
Employment costs (Note 1)	1,800
Other costs directly related to the construction (Note 2)	1200
General administrative overheads (not involved in factory construction)	600
Architects' and consultants' fees directly related to the construction	400
Costs of relocating staff who are to work at the factory	300
Costs relating to the formal opening of the factory	200

Note 1: The factory was constructed in the eight months ended 30 November 2015. It was brought into use on 31 December 2015. The employment costs are for the nine months to 31 December 2015. The employees were engaged in construction and related activities.

Note 2: Other costs directly related to the construction include an abnormal cost of Rs. 200, in respect of repairing the damage which resulted from a gas leak.

What will be the initial carrying value of the factory building?

Response

Paragraphs 16, 17 and 19 of Ind AS 16 state that:

"16 The cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

17 Examples of directly attributable costs are:

(a) costs of employee benefits (as defined in Ind AS 19 *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;

(b) costs of site preparation;

(c) initial delivery and handling costs;

(d) installation and assembly costs;

(e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

(f) professional fees.

19 Examples of costs that are not costs of an item of property, plant and equipment are:

(a) costs of opening a new facility;

(b) costs of introducing a new product or service (including costs of advertising and promotional activities);

(c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

(d) administration and other general overhead costs.

In accordance with the above paragraphs, the initial carrying value of the factory is computed as below:

Particulars	Amount (Rs. in thousands)	Amount capitalised (Rs. in thousands)	Remarks
Costs of dismantling existing structures on the site (demolition costs)	500	500	Site preparation costs which are directly attributable to the building (cost of getting the asset ready for use in the manner intended by the management)
Material consumed to construct the factory	6,000	6,000	Directly attributable cost
Employment costs	1,800	1,600	Employment costs for the period of 8 months are directly attributable. Therefore, costs to be capitalised is Rs. 1600 (i.e., 8/9 x 1,800)
Other costs directly related to the construction	1200	1,000	Directly attributable cost excluding abnormal cost
General administrative overheads	600	Nil	General overhead costs are not costs of an item of property, plant and equipment unless if it can be clearly demonstrated that they are directly attributable to construction

Architects' and consultants' fees directly related to the construction	400	400	Architects' fees should be capitalised since it is a directly attributable cost of getting the asset ready for use
Costs of relocating staff who are to work at the factory	300	Nil	This is not required for getting the asset ready for use
Costs relating to the formal opening of the factory	200	Nil	Specifically disallowed by Ind AS 16.This is not required for getting the asset ready for use
Total Cost	**11,000**	**9,500**	

Accordingly, the initial carrying value of the factory building is Rs. 9,500, 000**.**

Question 11

X Ltd. is in the business of manufacture and sale of chemicals. It has set up a new plant for manufacture of a new chemical. The Company conducted an initial trial run the main emphasis of which was to achieve the desired quality of output and continuous operation without breakdown. To achieve this, the Company commenced production which continued till the Company believed that the plant is properly adjusted and it may be construed as being ready for commercial production. The Company incurred various production costs such as raw materials cost, processing costs, etc. for manufacturing the product during this stage. The Company earned revenue from sale of products manufactured during the trial run period. How should the Company account for the production costs incurred and the revenue earned during this period?

Response

As per paragraph 17(e) of Ind AS 16, costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment), is included as an example of directly attributable costs.

Further, paragraph 20 of Ind AS 16, provides that recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. The following costs are not included in the carrying amount of an item of property, plant and equipment:

(a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;

(b) initial operating losses, such as those incurred while demand for the item's output builds up.

The production costs incurred during the trial run period were necessary for the purpose of determining whether the plant is ready for production. Even during experimentation period a plant may be engaged in actual production but until the test runs are completed and the plant is properly adjusted on the basis thereof it may not be said to be ready for production.

In view of the above, the Company should capitalise the production costs incurred as a directly attributable cost. The costs incurred after the point when asset is ready for its intended use should not be capitalised. The revenue earned from the sale of the products manufactured during the trial run should be deducted from the costs so incurred.

In any project which involves lengthy construction period, the selection of a "cut-off date" needs careful evaluation based on the date when the project is recognised as being ready for commercial production, especially in cases where commercial production is considerably delayed, to ensure that abnormal trial run costs or inefficiencies are not capitalised.

Question 12

Entity A intends to reconstruct its existing plant building. During the period of reconstruction, entity A intends to continue its normal operations of production of goods. For this purpose, Entity A decided to move its manufacturing facilities to a temporary site during the construction period. The following costs will be incurred on account of this activity: set-up costs of Rs. 200,000 to install plant in the new location, rent of Rs. 350,000 and costs of Rs. 50,000 to transport the machinery from the old location to the temporary site. Whether these costs be capitalised into the cost of the new building?

Response

As per paragraph 15 of Ind AS 16, an item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.

Further paragraph 16 of Ind AS 16, provides that, the cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Paragraph 20 also provides an example that costs of relocating or reorganising part or all of an entity's operation are not included in the carrying amount of an item of property, plant and equipment.

In the given case, costs to be incurred to relocate the existing manufacturing facilities to continue the operation is not a directly attributable cost. These costs are merely to be incurred so that the normal operation of production of goods is not hampered. These costs would have been avoided if the plant and building had not been constructed, and therefore are not necessary to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

In view of the above, the costs to be incurred by the entity do not meet the requirement of Ind AS 16 and therefore these costs cannot be capitalised.

Question 13

ABC Ltd. is engaged in retail business and it has a chain of departmental stores across the country. It has acquired a new store at another location. In order to start the new store significant renovation expenditure are required at that location and the management expects that the renovations would continue for the period of six months. Management has prepared the budget for this period including expenditure related to construction and remodelling costs, salaries of staff participating in hiring (not related to construction), salary costs of staff on the bench, training, etc.

Can ABC Ltd. capitalise all the costs incurred during the period of six months?

Response

As per paragraph 15 of Ind AS 16, an item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.

Further paragraph 16, *inter alia*, states that, the cost of an item of property, plant and equipment comprises, any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

In view of the above, the costs of construction and remodelling the departmental store, are necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management. The departmental store cannot be opened without incurring the remodelling expenditure, and thus the expenditure should be considered as a part of the asset. Therefore, ABC Ltd. should capitalise the costs of construction and remodelling the departmental store.

Further, paragraph 19 also states that examples of costs that are not costs of an item of property, plant and equipment are:

(a) costs of opening a new facility;

(b) costs of introducing a new product or service (including costs of advertising and promotional activities);

(c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

(d) administration and other general overhead costs.

The cost of salaries of staff on the bench, staff participating in training, hiring, etc are operating expenditures. These costs are not necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management and should be expensed.

However, salary, if any, paid to workers for renovation of store should be capitalised.

Question 14

An entity G Ltd. is setting up a new plant. It sets up a project team comprising existing employees who will be responsible for setting up the new plant. The employees will work on a full-time basis and installation is expected to take eight weeks. Whether the cost of the project team including all employee benefits which will be paid otherwise should be capitalised?

Response

As per paragraph 17 of Ind AS 16, one of the examples of directly attributable cost is employee benefits (as defined in Ind AS 19 *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment.

In view of the above, the cost of the project team, including all employee benefits, during the period of installation is directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management, therefore the same should be included in the cost of the new plant. These costs are to be capitalised even if these costs would have been incurred otherwise also because for cost to be directly attributable it need not to be external.

Question 15

Company XYZ plans to construct a hotel on a site which is currently occupied by the residents of a small town. The Company XYZ agrees to pay the cost of relocating the residents to another site. Whether the cost of relocating should be capitalised as part of the cost of land for the hotel?

Response

As per paragraph 15 of Ind AS 16, an item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.

Further paragraph 16, *inter alia*, states that, the cost of an item of property, plant and equipment comprises any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

In view of the above, the cost of relocating the existing residents should be capitalised to the cost of land because the relocation is a direct result of the decision to acquire the land and is in the nature of cost of site preparation. Hence, it is directly attributable cost to bring the land to the condition necessary for it to be capable of operating in the manner intended by management.

Question 16

A public sector company is engaged in refining and marketing of petroleum products. The company has entered into engineering agreements with a foreign licensor for transfer of know-how for installation of petrochemical plant at one of its refineries. The know-how can be used only for the company's own use and cannot be sold or transferred or leased to others. As per the agreement, the licensor will provide engineering and technical services in connection with the design of the plant. Whether the cost of technical know-how fee related to plant design incurred under the engineering agreement is to be capitalised as intangible asset or as a part of the relevant plant?

Response

In the given situation, to determine whether know-how should be capitalised as an intangible asset or as a part of relevant plant, judgement needs to be exercised as to which element is more significant, the property, plant or equipment element or intangible element. The entity should evaluate whether any intangible part is actually integral to the larger asset or whether it is really a separate asset in its own right. In the present case, the technical know-how is integral to the plant which is required for installation of the petrochemical plant. The know-how can be used only for the company's own use and cannot be sold or transferred or leased to others.

Further paragraph 16 of Ind AS 16, *inter alia*, states that any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management should be included in the costs of an item of property, plant and equipment.

The cost of a self-constructed asset is also determined using the same principles as for an acquired asset.

Since know-how has been acquired for installation of the plant and considering it will be used for installation of this plant only, the cost of know-how should be capitalised as part of cost of relevant plant as directly attributable cost.

Question 17

A manufacturing company enters into a contract with a supplier to procure equipments over a period of 3 years. The Company has to pay cancellation fees for terminating the contract. The cancellation fees would only be in respect of those equipments which are not procured by the Company as per the contract.

The Company decides to terminate the contract at the end of year 1 since it has identified another supplier which would result in a significant reduction in cost for the company. It pays the cancellation fees in respect of the remaining equipments not yet procured. Whether the cancellation fee paid by the Company should be capitalised as part of the cost of the equipment purchased?

Response

As per paragraph 15 of Ind AS 16, an item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.

Further paragraph 16, *inter alia*, states that, the cost of an item of property, plant and equipment comprises, any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by the management.

In view of the above, the cancellation fees incurred is not directly attributable costs as they are not directly related to the acquisition of the equipment and are not required to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. Hence, the cancellation fee should not be capitalised as part of the cost of the equipments purchased from another supplier, instead it should be expensed off as and when incurred.

Question 18

An entity has employed a contractor for construction of chemical plant. The terms of the agreement clearly specify that the liquidated damages are paid as compensation for failure to meet performance conditions in terms of the desired quality and level of output subsequent to commissioning of the plant. The damages will be calculated based on the shortfall in the output as a percentage of the contract price. Whether such liquidated damages received be deducted from the cost of the related asset or recognised as income?

Response

Paragraph 16 of Ind AS 16, *inter alia*, states that, the cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management…”

In the given case, the amount of liquidated damages received are not directly attributable to the construction of the chemical plant like trade discounts and rebates. Such damages are as a result of the inefficiencies on the part of the contractor. Further, the amount of liquidated damages is directly linked to performance parameters for the plant subsequent to commissioning of the plant. Therefore, the liquidated damages should not be deducted from the cost of related asset and the same should be accounted as income.

Question 19

An entity PQR Ltd. employed a contractor to build a power plant on turnkey project basis for a total consideration of Rs. 100 crores. As per the terms of the contract, if there is more than one month delay in the completion of construction, PQR Ltd. is entitled to recover liquidated damages at 0.25% of the contract value for every week of delay subject to the maximum of 5% of contract value.

The contractor delayed the completion of construction by 45 days and therefore, PQR Ltd. received liquidated damages from the contractor. The management believes that liquidated damages basically compensate it for its loss of revenue for the period of 45 days. What will be the treatment of these liquidated damages received on delays by the contractor?

Response

Paragraph 16 of Ind AS 16, *inter alia*, states that "the cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management…"

The treatment of liquidated damages received on delays by the contractor depends on the facts and circumstances. Hence, whether or not the liquidated damages should be adjusted against the project cost would depend upon the fact whether the liquidated damages are directly identifiable with the project and whether, in fact, they are received for mitigating extra project costs to be incurred by the entity which will be capitalised as part of the cost of the plant. Where and to the extent the liquidated damages meet the aforesaid stipulations in affirmative, the same should be adjusted in the cost of the project. Otherwise the same should be accounted for as income.

Question 20

A company acquires a land with an existing building for a consideration of Rs.1 crore. The company has no intention of using the existing building. The fair market value of the land is Rs. 80 lakhs and that of the building is Rs.20 lakhs. The planned redevelopment necessitates the demolition of that building and its replacement with a new building as an owner occupied property. How the acquisition of land with the existing building will be accounted for in the books of accounts of the real estate developer?

Response

Paragraph 58 of Ind AS 16, *inter alia*, states that, land and buildings are separable assets and are accounted for separately, even when they are acquired together.

In accordance with above paragraph, in ordinary course, on initial recognition, the building and land should be recognised as two separate items of property, plant and equipment under Ind AS 16.

However, in the given case, the entity has no intention of utilising the existing building for its business activities and the acquisition does not relate to a group of assets being acquired. The existing building is unusable to the entity and the same is to be demolished after acquisition.

Thus, although the company has acquired both land as well as building and fair values of the land and existing building are available, the purpose of acquiring the land is to construct a new building for self-occupation. The entity has no intention of utilising the existing building for self-occupation. Accordingly, the amount paid for building should be included in the cost of land, i.e., the entire amount of Rs.1crore should be treated as cost of land.

Question 21

Company A is constructing a building for its business use. The construction of the building is interrupted because of protests by the farmers for additional compensation for land sold by them in that area for an indefinite period. Company A continues to incur certain fixed cost. Whether such fixed costs, including abnormal costs, incurred during the period of interruption will be capitalised to the cost of building?

Response

With regard to self-constructed assets, paragraph 22 of Ind AS 16, *inter alia*, provides that the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset.

In addition to the above, following paragraph of Ind AS 23 '*Borrowing Costs*' regarding suspension of capitalisation of borrowing costs may be considered:

"21 An entity may incur borrowing costs during an extended period in which it suspends the activities necessary to prepare an asset for its intended use or sale. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, an entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work. An entity also does not suspend capitalising borrowing costs when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period that high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographical region involved."

Based on the principles of Ind AS 23, the cost incurred during an interruption should also be capitalised only if the interruption is temporary and is a necessary part of bringing the asset to the condition for it to be capable of operating in the manner intended by the management e.g. the cost of delays for obtaining permits for the eventual operation of the asset.

In the given case, interruption due to protest by farmers for additional compensations is not a necessary part of bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Moreover, the interruption is not a temporary delay or routine in nature. Accordingly, such interruption is abnormal in nature. Therefore, fixed costs incurred during the period of interruption should not be capitalised to the cost of building.

Question 22

A public sector company is engaged in refining, transportation and sale of petroleum products. It incurs demurrage on imported plant and machinery. Demurrage represents payment made for detention of imported plant and machinery at discharge location for a period more than the period agreed with the supplier/transporter. The incidence of demurrage was on account of a nationwide transporters strike due to which the company could not take delivery of the machinery.

Whether demurrage should be considered as an element of cost for the purpose of determining the cost of imported plant and machinery?

Response

Paragraph 16 of Ind AS 16, *inter alia*, provides that the cost of an item of property, plant and equipment comprises any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

Further paragraph 22 of Ind AS 16, *inter alia*, provides that the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset.

Demurrage represents payment made for detention of imported plant and machinery at discharge location for a period more than the period agreed with the supplier/transporter. Considering the nature of demurrage, as a general rule, demurrage would represent an abnormal cost and hence should not be included as an element of cost. However, incurrence of demurrage may sometimes represent a normal cost considering the specific facts and circumstances of the particular case, for example, where the incidence of demurrage may be directly related to a reduction in other costs which, if incurred, would qualify for inclusion in the cost of an item of property, plant and equipment.

In the instant case, demurrage is incurred on account of a nationwide transporters strike, which represents abnormal cost. Therefore, the demurrage should not be capitalised for the purpose of determining the cost of imported plant and machinery and should be expensed in the year of incurrence.

Question 23

Entity X has a warehouse which is closer to factory of Entity Y and vice versa. The factories are located in the same vicinity. Entity X and Entity Y agree to exchange their warehouses. The carrying value of warehouse of Entity X is Rs. 1,00,000 and its fair value of Rs. 1,25,000. It exchanges its warehouse with that of Entity Y, the fair value of which is Rs.1,20,000. It also receives cash amounting to Rs.5,000. How should Entity X account for the exchange of warehouses?

Response

Paragraph 24 of Ind AS 16, *inter alia*, provides that when an item of property, plant and equipment is acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets, the cost of such an item of property, plant and equipment is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

Further as per paragraph 25 of Ind AS 16, an entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

(b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and

(c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

In the given case, the transaction lacks commercial substance as the company's cash flows are not expected to significantly change as a result of the exchange because the factories are located in the same vicinity i.e. it is in the same position as it was before the transaction. Hence, Entity X will have to recognise the assets received at the carrying amount of asset given up, i.e., Rs. 1,00,000 being carrying amount of existing warehouse of Entity X. and Rs. 5,000 received will be deducted from the cost of property, plant and equipment. Therefore, the warehouse of Entity Y is recognised as property, plant and equipment with a carrying value of Rs. 95,000 in the books of Entity X.

Measurement after recognition

Question 24

If the revaluation model is adopted, Ind AS 16 specifies that all items within a class of asset are to be revalued simultaneously to prevent selective revaluations. What does 'class of asset' represent?

Response

As per paragraph 36 of Ind AS 16, if an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

Further paragraph 37 of Ind AS 16 provides that, a class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. Following are examples of separate classes:

(a) land;

(b) land and buildings;

(c) machinery;

(d) ships;

(e) aircraft;

(f) motor vehicles;

(g) furniture and fixtures ;

(h) office equipment; and

(i) bearer plants.

The above-mentioned is a broad illustration of the classes of assets and it is possible that there may be other classes of assets based on their similar nature and use. For example, buildings could be further classified as office buildings and factory buildings as separate classes of asset. Similarly, machinery may also be classified based on use for example, mining machinery, captive power plants, pollution control equipment etc.

Ultimately it is a matter of judgement in the context of the specific operations of an individual entity.

However, the entity needs to provide the disclosure as required by paragraph 73 of Ind AS 16 for each class of property, plant and equipment.

Question 25

Company A has textile manufacturing facilities in two different geographical locations for similar products or products with similar markets. The company wants to classify both the manufacturing facilities as different class of property, plant and equipment, based on their different geographical location. Whether the company is permitted to do so? Would the response be different if the company manufactured different products, say pharmaceuticals and textiles in the same geographical location?

Response

No, the Company A cannot classify both the manufacturing facilities as separate class of property, plant and equipment.

Paragraph 37 of Ind AS 16, *inter alia,* provides that a class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations.

According to the above, in the given case, the different geographical locations do not justify to classify the assets in different classes, as the manufacturing facilities in both regions are used for manufacturing similar products. Hence, the manufacturing facilities in both the locations should be classified as one class of property, plant and equipment.

However, if the entity manufactured pharmaceuticals and textiles, both in the same geographical location, then these could be classified as a separate class if it is sufficiently justified that the assets are of different nature and use as the nature and use of the assets should be assessed with respect to the business segment for which they are used, rather than their geographic location.

Company A needs to provide the disclosure as required by paragraph 73 of Ind AS 16 for each class of asset.

Question 26

Entity A acquired Entity B and measured the assets acquired at the acquisition date fair values in accordance with the requirement of Ind AS 103.

Ind AS 16 prescribes that where an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs should be revalued. In accordance with Ind AS 103 does this mean that Entity A is required to revalue its own existing tangible fixed assets that are classified in the same class of assets?

Response

As per paragraph 18 of Ind AS 103, *Business Combinations*, the acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values. Accordingly, Entity A measured the fixed assets acquired at the acquisition date fair values.

The fair value measurement of assets acquired as per the requirements of Ind AS 103 does not mean that revaluation has taken place from a group's perspective. The acquisition date fair value is just an initial recognition of the asset at cost (which is fair value in this case). It does not tantamount to adoption of revaluation model by the entity as per Ind AS 16. It is only an allocation of the purchase price (for initial recognition) as part of the cost model and does not relate to revaluation.

Therefore, the existing tangible fixed assets of the same class held by the group do not need to be revalued assuming that the group has a policy of measuring its assets at cost.

Question 27

An entity has recognised some assets held under finance lease as property, plant and equipment in its balance sheet. The entity has also recognised items of property, plant and equipment owned by it, of similar nature and use. The entity uses the revaluation model prescribed under Ind AS 16 for the entire class of property, plant and equipment. Whether property, plant and equipment held under finance lease are classified as a separate class of assets from the assets owned by the entity?

Response

Paragraph 4 of Ind AS 16 provides that-

"Other Indian Accounting Standards may require recognition of an item of property, plant and equipment based on an approach different from that in this Standard. For example, Ind AS 17 *Leases* requires an entity to evaluate its recognition of an item of leased property, plant and equipment on the basis of the transfer of risks and rewards. However, in such cases other aspects of the accounting treatment for these assets, including depreciation, are prescribed by this Standard".

From the above paragraph, it is evident that once the item of property, plant and equipment is recognised based on approach different from Ind AS 16, other aspects of accounting treatment prescribed in Ind AS 16 have to be followed. Revaluation of property, plant and equipment is carried out subsequent to the recognition. Accordingly, principles enunciated in the Standard in this regard will apply.

With regard to revaluation, paragraph 36 of Ind AS 16 provides that if an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs should be revalued.

Further, as per paragraph 37 of Ind AS 16, a class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. In these paragraphs, no distinction has been made between owned and finance leased items of property, plant and equipment. Moreover, the definition of property, plant, and equipment does not distinguish between how assets are financed.

In view of the above paragraphs, the assets that are held under a finance lease and owned assets of similar nature and use should be classified as one class of assets and revaluation principles will apply to the entire class of assets.

Question 28

Company X performed a revaluation of all of its plant and machinery at the beginning of 2015. The following information relates to one of the machinery:

	Amount('000)
Gross carrying amount	Rs. 200
Accumulated depreciation (straight-line method)	Rs. 80
Net carrying amount	Rs. 120
Fair value	Rs. 150

The useful life of the machinery is 10 years and the company uses Straight line method of depreciation. The revaluation was performed at the end of 4 years.

How should the Company account for revaluation of plant and machinery and depreciation subsequent to revaluation?

Response

According to paragraph 35 of Ind AS 16, when an item of property, plant and equipment is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:

(a) The gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated depreciation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses; or

(b) The accumulated depreciation is eliminated against the gross carrying amount of the asset.

The amount of the adjustment of accumulated depreciation forms part of the increase or decrease in carrying amount that is accounted for in accordance with the paragraphs 39 and 40 of Ind AS 16.

If the Company opts for the treatment as per option (a), then the revised carrying amount of the machinery will be:

Gross carrying amount	Rs. 250	[(200/120) X 150]
Net carrying amount	Rs.150	
Accumulated depreciation	Rs. 100	(Rs.250 – Rs.150)

Journal entry

Fixed Assets (Gross Block) Dr. Rs. 50

To Accumulated Depreciation Rs. 20

To Revaluation Reserve Rs. 30

If the balance of accumulated depreciation is eliminated as per option (b), then the revised carrying amount of the machinery will be as follows:

Gross carrying amount is restated to Rs.150 to reflect the fair value and Accumulated depreciation is set at zero.

Journal entry

Accumulated Depreciation	Dr. Rs.80
To Fixed Asset (Gross Block)	Rs. 80
Fixed Asset (Gross Block)	Dr. Rs. 30
To Revaluation Reserve	Rs. 30

Depreciation

Option (a) – Since the Gross Block has been restated, the depreciation charge will be Rs. 25 per annum (Rs.250/10 years).

Option (b) – Since the Revalued amount is the revised Gross Block, the useful life to be considered is the remaining useful life of the asset which results in the same depreciation charge of Rs. 25 per annum as per Option A (Rs.150/6 years).

Depreciation

Question 29

In accordance with Schedule II of the Companies Act, 2013, if the company uses a different useful life than as specified in Schedule II or a residual value of more than 5%, it is required to disclose the same in the financial statements and provide justification duly supported by the technical advice. Whether such technical advice is to be necessarily obtained from external experts?

Response

The Company may obtain technical advice from external or internal experts.

Irrespective of whether the useful life is determined as per the Schedule II to the Companies Act, 2013 a company should evaluate the reasonableness of the useful life of assets. Schedule II to the Companies Act, 2013 is silent regarding whether the technical advice is to be necessarily obtained from external experts.

Determination of useful life is a matter of judgement and may be decided on a case to case basis. If a company has adequate internal technical expertise, it may be appropriate for the companies to rely on the judgments of such internal experts regarding the useful lives and residual value of the property, plant and equipment. It should be supported by adequate documentation to be able to demonstrate that the company has obtained advice from such internal technical experts and the criteria and assumptions involved in making such determination of useful lives and residual value.

Question 30

A manufacturing company has recently acquired a new factory, which cost Rs. 15,00,000 for the freehold land and building. The land has a fair value of Rs 5,00,000. The factory building has a residual value of Rs. 1,00,000 at the end of 30 years, which is the expected useful life of the building. This factory has a flat roof, which needs replacement after every ten years. The current cost of replacement is Rs. 1,00,000. How should the Company depreciate the entire factory?

Response

As per paragraph 43 of Ind AS 16, each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

The company may consider the roof as a significant part of the item and depreciate the cost of the roof of Rs. 1,00,000 over the period of 10 years, giving a depreciation charge of Rs. 10,000 per annum and to depreciate the remaining value of the factory of Rs. 9,00,000 to its residual value of Rs. 1,00,000 over 30 years, giving depreciation charge of Rs. 26, 667.

At the end of year 10 when the roof will be replaced the carrying amount attributable to the replaced roof would be nil, with no profit or loss on disposal.

In the given case, the economic benefits arising from the factory over 30 years is reflected through charge to the statement of profit and loss of Rs. 26,667 per annum as depreciation for the building and depreciation charge of Rs. 10,000 for the flat roof over its useful life.

Question 31

Company A has purchased a captive power plant for Rs. 75 crores. Plant consists of significant components like boiler, turbine blades and generator. Company applies component accounting and depreciate all the 3 components as per their respective useful life. Company does not have the breakup of cost component wise in the invoice. How will the total cost be allocated to the components?

Response

In case, the separate cost of each significant component of an asset is not available in the books of account then for the purpose of determining the cost of such component, the following criteria can be used in the order given below:

(a) Break-up cost provided by the vendor;

(b) Cost break-up given by internal/external technical expert;

(c) Fair values of various components; or

(d) Current replacement cost of component of the related asset and applying the same basis on the historical cost of asset.

Question 32

A Company acquires a ship for Rs. 500 crores. The useful life of the ship is 20 years. The ship is mandatorily required to undergo major periodic inspection and repairs as per statute (dry-docking) at least once in every three years. Dry-docking costs are estimated to be Rs. 100 crores for similar ships based on current market price which comprises of inspection costs of

Rs.30 crores and replacement of parts amounting to Rs.70 crores. How will the company treat these dry dock cost when incurred?

Response

Paragraph 13 of Ind AS 16, *inter alia,* states that parts of some items of property, plant and equipment may require replacement at regular intervals. Under the recognition principle in paragraph 7, an entity recognises in the carrying amount of an item of property, plant and equipment , the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard.

Paragraph 14 of Ind AS 16, *inter alia*, states that, a condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised.

Further, paragraphs 43 and 44 of Ind AS 16 states that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately. An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease. Similarly, if an entity acquires property, plant and equipment subject to an operating lease in which it is the lessor, it may be appropriate to depreciate separately amounts reflected in the cost of that item that are attributable to favourable or unfavourable lease terms relative to market terms.

In accordance with the above provisions of Ind AS 16, it may be noted that not all dry docking costs incurred are capitalised. Dry docking costs incurred on items which meet the recognition criteria are capitalised. Otherwise, the same may be charged to the profit and loss.

In the given case, the company should recognise the cost of replacing part of Rs. 70 crores in the carrying amount of the ship, if the recognition criteria laid down in the paragraph 7 of Ind AS 16 is met. The carrying amount of replaced parts should be derecognised. The company will depreciate the cost of parts to be replaced totalling to Rs.70 crores over the period of three years in accordance with paragraph 13 of Ind AS 16. Major inspection cost amounting to Rs. 30 crores should also be recognised in the carrying amount of the ship and the same will be depreciated over the period of three years till the next dry-docking.

Question 33

An entity buys five machines for use in its manufacturing facility. Simultaneously it purchases a spare motor which can be used as a replacement in case the motor of any one of the five machines breaks down. The motor will be used in the production of goods and, once brought into service, will be operated during more than one period. How should the spare motor be accounted for?

Response

As per paragraph 8 of Ind AS 16, items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Ind AS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.

In accordance with the above, the spare motor is classified as property, plant and equipment.

Spare parts will have to be depreciated along with the corresponding main asset. The depreciation period for any spare part capitalised should not exceed its useful life. Spare parts are depreciated when they are available for use. Hence, the motor should be depreciated when available for use over the lesser of its useful life and the remaining useful life of the asset to which it relates.

Question 34

An automotive company ABC has various types of tools that are used in the car manufacturing process. These tools are specific to a particular variant of a car and cannot be used for any other purpose. The number of units that can be produced or serviced through the use of these tools is estimated based on their utilisation and the company maintains a detailed five year production plan. Can the Company apply the units of production (UOP) method of depreciation?

Response

Ind AS 16 defines useful life as: (a) the period over which an asset is expected to be available for use by an entity; or (b) the number of production or similar units expected to be obtained from the asset by an entity.

The Standard requires that the depreciable amount of an asset shall be allocated on a systematic basis over its useful life. Depreciation of an asset begins when it 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 management. Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105 and the date that the asset is derecognised. Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. Depreciation is a function of several factors, with extent of usage and efflux of time being its primary determinants. The units of production method relates the amount of periodic depreciation charge only to one of the above two factors, namely, the extent of usage as reflected by the number of units of output. This method may therefore be said to be appropriate only where the facts and circumstances are such that the efflux of time would have no additional impact than already recognised by the depreciation charge based on unit of production.

Paragraph 62 of Ind AS 16 states that, "a variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method. Straight-line depreciation results in a constant charge over the useful life if the asset's residual value does not change. The diminishing balance method results in a decreasing charge over the useful life. The units of production method results in a charge based on the expected use or output. The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits."

Based on the above, the depreciation of the tools can be provided based on the number of units expected to be obtained from the use of the asset, generally known as the UOP method. The Company maintains a detailed five year plan production plan so that it is able to reliably estimate the number of units that can be used or serviced through the use of these tools. By relating depreciation to the proportion of productive capacity the depreciation method reflects the pattern in which the future economic benefits are expected to be consumed by the entity.

Company ABC should periodically review the number of units that can be produced or serviced from the asset in the future. Where such an asset is idle for a long period of time, the Company should assess whether the use of UOP method is still appropriate.

Compensation for impairment

Question 35

Entity A has five manufacturing units across India. On 1 April, 2015, a major fire broke at one of the manufacturing units. All the fixed assets are insured under a fire insurance policy. The carrying value of the fixed assets in the manufacturing unit was Rs. 8 crores. Entity A received the insurance claim amounting to Rs. 12 crores including Rs. 10 crores for reconstructing the unit and Rs. 2 crores for loss of profits. The actual cost of rebuilding the unit is Rs. 11 crores. How will the Entity A account for the same?

Response

Paragraphs 65 and 66 of Ind AS 16, state that-

> "65 Compensation from third parties for items of property, plant and equipment that were impaired, lost or given up shall be included in profit or loss when the compensation becomes receivable.
>
> 66 Impairments or losses of items of property, plant and equipment, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately as follows:
>
> (a) impairments of items of property, plant and equipment are recognised in accordance with Ind AS 36;
>
> (b) derecognition of items of property, plant and equipment retired or disposed of is determined in accordance with this Standard;

(c) compensation from third parties for items of property, plant and equipment that were impaired, lost or given up is included in determining profit or loss when it becomes receivable; and

(d) the cost of items of property, plant and equipment restored, purchased or constructed as replacements is determined in accordance with this Standard."

In accordance with the above paragraphs, impairment and any related compensation are 'separate economic events' and should be accounted separately as follows:

(a) impairments of property, plant and equipment are recognised in accordance with Ind AS 36;

(b) derecognition of items retired or disposed of should be recognised in accordance with Ind AS 16; and

(c) compensation from third parties for property, plant and equipment that is impaired lost or given up is included in profit and loss when it becomes receivable.

Therefore any compensation is accounted for separately from any impairment.

The Company will recognise the following in accordance with paragraph 66 of Ind AS 16:

(a) Loss of Rs. 8 crores for writing off the carrying value of the manufacturing unit;

(b) Insurance claim receivable of Rs. 12 crores when it becomes receivable as compensation for loss of manufacturing unit (to be included in Other Income);

(c) Cost of reconstruction of manufacturing unit amounting to 11 crores will be considered as new item of property, plant and equipment.

Derecognition

Question 36

An entity buys a piece of machinery with an estimated useful life of ten years for Rs.1 crore. The asset contains two identical pumps, which are assumed to have the same useful life as the machine of which they are a part. After seven years, one of the pumps fails and is replaced at a cost of Rs. 2,00,000. The entity had not identified the pumps as separate parts and does not know the original cost. How will the company account for the replacement of pump?

Response

Paragraph 43 of Ind AS 16 states that, "each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately."

Accordingly, an entity needs to identify the significant parts of the asset on initial recognition in order to depreciate the asset properly otherwise the Standard does not mandate identification of all the parts separately.

Further, paragraph 70 of Ind AS 16, *inter alia,* provides that if, under the recognition principle in paragraph 7, an entity recognises in the carrying amount of an item of property, plant and equipment the cost of a replacement for part of the item, then it derecognises the carrying amount of the replaced part, regardless of whether the replaced part had been depreciated separately. It further requires that if it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed. As a consequence, an entity may not actually identify the parts of an asset until it incurs the replacement expenditure.

In accordance with the above provisions of Ind AS 16, in the given case, the entity should use the cost of the replacement to estimate the carrying value of the original pump. With the help of the supplier, let's assume it estimates that the cost would have been approximately Rs. 1,70,000 and that this would have a remaining carrying value after seven years depreciation of Rs. 51,000. Accordingly, the entity derecognises Rs. 51,000 from net block and capitalise the cost of the replacement of Rs 2,00,000.

As per paragraph 71 of Ind AS 16, the gain or loss from the derecognition of an item of property, plant and equipment shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

In the present case, the net disposal proceeds are nil. Therefore, loss on derecognition is Rs. 51,000.

Accordingly, accounting entries will be passed as under:

Profit & loss A/c (Loss on disposal) Dr. Rs. 51,000

Accumulated Depreciation Dr. Rs.1,19,000

To Gross Block (Old pump) Rs.1,70,000
(For derecognising the carrying amount of old pump)

Gross Block (Replaced Part) Dr. Rs.200,000

To Bank A/c Rs.2,00,000
(For recognising replaced part)

Other Issues

Question 37

A public sector company is manufacturing industrial chemicals and fertilizers. During manufacturing the same, it uses many inputs as well as catalysts. As per design, catalysts are directly used in the production process to facilitate reaction. As these catalysts do not participate in the reaction these are classified as process chemicals and consumables rather than raw material inputs. Catalysts are of high value. Such catalysts are replaced when their charge gets over or does not support the performance as desired. The company uses various catalysts in its production which is product/plant specific. The charge of some of the catalysts, normally called as the life of the catalyst, may be over in one year whereas sometimes it gets extended up to 5 to 7 years. The first charge of the catalyst is capitalised along with the plant. Whether the catalyst will be classified as inventory or property, plant and equipment?

Response

The catalysts having high values are used in the production process. The catalysts generally have a life more than one year although the life may fluctuate considerably keeping in view the conditions in which the same is used. Further, a catalyst may be reused after recharging the same. Once a catalyst becomes completely useless it is disposed off as scrap.

A catalyst meets the definition of an asset since it is a resource controlled by the enterprise from which its future economic benefits are expected to flow to the enterprise.

To determine whether the catalysts should be classified as inventory or an item of property, plant and equipment, following definitions may be noted:

As per paragraph 6 of Ind AS 2, *Inventories* are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Further as per Ind AS 16, property, plant and equipment are 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.

The catalyst is an asset that facilitates the process that increases the future economic benefits, output efficiency expected from the plant. Accordingly, the catalyst is in the nature of a property, plant and equipment as contemplated in Ind AS 16.

On the other hand, if the catalyst is used in the process of production and is of the nature of supply to be consumed in the production process, it should be considered of the nature of a consumable even though its life may be greater than one year. In other words, if a catalyst is covered by the definition of the term 'inventories' under Ind AS 2, the catalyst should be classified as inventory.

Question 38

XYZ Limited was negotiating a deal to purchase large plant and machinery. During the negotiations, XYZ Limited had asked for minimum 1 % additional discount. Since the vendor was also not agreeable to give this discount, the broker agreed to pass on 75% of its sales commission (that it received from the vendor) to XYZ Limited so as to induce it to purchase the machinery. Based on this offer, the final deal was struck and XYZ purchased the machine.

The management of XYZ Limited is of the view that it has not received commission rebate from the vendor and therefore it cannot be reduced from the cost of machinery. Rather, it should be treated as other income in the period in which it purchased the machine. Is the management view tenable?

Response

Paragraph 16 (a) of Ind AS 16, *inter alia*, requires that the cost of an item of PPE comprises its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates. It does not matter whether such discounts or rebates are received from the vendor directly or indirectly through the broker. Therefore, the commission passed on by the broker is in the nature of trade discounts and rebates received.

Moreover, XYZ Ltd. has entered into only one transaction, i.e., purchase of the machine and from the facts of the case, it is clear that XYZ Ltd. asked for a minimum discount to buy the machine. Accordingly, the cost of acquisition of the machine is net of the amount of commission passed on by the broker to the entity, therefore, the commission passed on by the broker should be deducted from the purchase price of the plant and machinery.

Question 39

XYZ Limited has set up a power generation project to exploit the hydroelectric potential of river basin. As per the regulatory requirements, XYZ Ltd. will have to incur rehabilitation and resettlement expenditures for the project affected families. The work of the Rehabilitation and Resettlement (R&R) is being carried out by R&R Department of XYZ Ltd which has been specifically set up for the purpose of the project. Rehabilitation and Resettlement expenditures include expenditure on set-up of office for rehabilitation purposes, payment of land compensation awards, development of infrastructure, etc. Whether the expenditure incurred on R&R work should be capitalized as a part of the cost of the project?

Response

Paragraph 7 of Ind AS 16 provides that the cost of an item of property, plant and equipment shall be 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.

Further, paragraph 16 of Ind AS 16, *inter alia*, states the cost of an item of property, plant and equipment comprises any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

In the given case, the Rehabilitation and Resettlement (R&R) expenditure, including the establishment and related expenditure, has been incurred by the XYZ Ltd. as a direct consequence of the setting up of the power generation project. The R&R department is doing only the work of land acquisition and related activities and is not engaged in any operation and maintenance work. Though the R&R office expenditure is administrative in nature, it is specifically attributable to the project and not general in nature.

Thus, it is a directly attributable cost and should be capitalised as a part of cost of the project.

Decommissioning, restoration and similar liabilities

Question 40

Company ABC has received a land on lease for 99 years from the government to carry out its activities. As per the terms and conditions of the lease, the Company is supposed to return the land to the government after 99 years on a "as it is where it is basis". At the inception of the lease the land is utilised by the company and a building has been constructed.

As per Ind AS 16, the cost of an item of property, plant and equipment comprises the initial estimate of the cost of dismantling and removing the item and restoring the site on which it is located. Management is of the view that the scrap value derived at the end of the lease period from the demolition of the project will compensate for the cost of demolition of the project.

How should the Company account for such decommissioning and restoration costs?

Response

As per paragraph 16 of Ind AS 16, the cost of an item of property, plant and equipment, inter alia, comprises the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Ind AS 37 contains requirements on how to measure decommissioning, restoration and similar liabilities. In addition, appendix A to Ind AS 16 provides guidance on how to account for the effect of changes in the measurement of existing decommissioning, restoration and similar liabilities.

Paragraph 8 of Appendix A of Ind AS 16 states that the periodic unwinding of the discount shall be recognised in profit or loss as a finance cost as it occurs. Capitalisation under Ind AS 23 is not permitted.

In this case, the decommissioning liability would be the liability associated with the costs of demolishing the building and making good the land to be returned to the government as per the terms and conditions of the agreement without considering the scrap value which will be derived from the demolition of the project at the end of the lease period.

All site restoration costs and other environmental restoration and similar costs need to be estimated and capitalised at initial recognition, in order that such costs can be recovered over the life of the item of property, plant and equipment even if the expenditure will only be incurred at the end of the item's life.

Where an obligation exists to dismantle or remove an asset or restore a site to its former condition at the end of its useful life, the present value of the related future payments is capitalised along with the cost of acquisition or construction upon completion and a corresponding liability is recognised.

The total decommissioning cost is estimated, discounted to its present value and it is this amount which forms the initial provision. This 'initial estimate of the costs of dismantling and removing the item and restoring the site' is added to the corresponding asset's cost. Thereafter, the asset is depreciated over its useful life, while the discounted provision is progressively unwound, with the unwinding charge shown as a finance cost.

Appendix I

Note: *The purpose of this Appendix is to bring out the major differences, if any between Indian Accounting Standard (Ind AS) 16 and existing Accounting Standard (AS) 10, Property, Plant and Equipment.*

Major differences between Ind AS 16, *Property, Plant and Equipment*, and existing AS 10, *Property, Plant and Equipment*

(i) Ind AS 16 does not deal with the assets 'held for sale' because the treatment of such assets is covered in Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations*. Existing AS 10 deals with accounting for items of fixed assets retired from active use and held for sale.

(ii) Ind AS 16 provides guidance on measuring 'Stripping Costs in the Production Phase of a Surface Mine'. Existing AS does not contain this guidance.