Property, plant and equipment - Directly attributable costs and component accounting

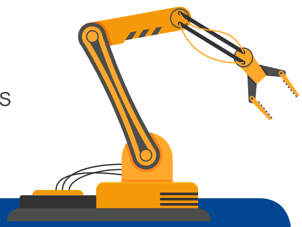
This article aims to:

- Discuss the key elements of directly attributable cost of property, plant and equipment and the guidance provided in the standards regarding component accounting.

Introduction

The accounting of Property, Plant and Equipment (PPE) under Accounting Standards and Ind AS has been aligned by the Institute of Chartered Accountants of India for all entities. Generally, for many entities PPE is a significant item on the balance sheet. Therefore, it is important that capitalisable costs are appropriately identified and the cost of the same is recognised over the period as depreciation.

In this article, we discuss the key elements of costs of PPE and the guidance provided in the standards regarding component accounting.



Cost of an item of PPE includes its net purchase price (including taxes), directly attributable expenditure to bring it to its intended use and estimated restoration cost (where applicable). While identification of net purchase price may involve very little judgement, identification of directly attributable expenditure requires a deeper understanding of the asset's intended use and the nature of the expenditure.

Directly attributable expenditure

Measurement of an asset includes all 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 (its intended use). The following are the types of directly attributable expenses:

- Costs of employee benefits incurred by the company for employees working directly in the construction or acquisition of an item of PPE costs of site preparation; initial delivery and handling costs
- Installation and assembly costs
- Costs of testing whether the asset is functioning properly; and fees paid to professional consultants assisting in the asset's installation.

Directly attributable expenditure need not necessarily be external or incremental. For example, cost of employees who are on the payroll of an entity and were fully engaged in installing an item of PPE is a directly attributable expenditure (for the period of installation), and so would be capitalised as part of the PPE.

Expenditure necessary in ensuring that the PPE is capable of operating in the manner intended by management could include a wide range of costs which needs to be assessed for each case based on its facts and circumstances.

Following are situations which highlight whether certain expense or income be treated as a directly attributable expense:

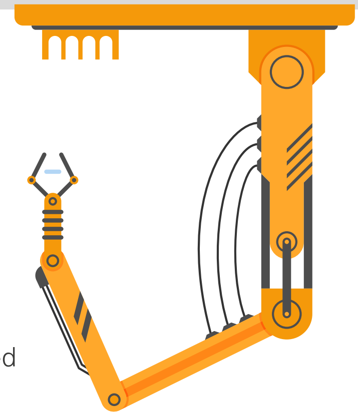
- **Pre-operative costs and losses:** Start-up and pre-operative costs are not capitalised as part of the PPE unless those costs are necessary to bring the asset to its working condition. For example, a company that is opening a new plant in a town where it has not previously operated, may need to obtain general permits that allow it to conduct business in the town. In this example, we believe that the cost of the permits should not be capitalised because they are a general business cost that does not relate specifically to the asset.

  An entity may incur current losses before the asset reaches its planned performance level. Such losses are not capitalised.

- **Income arising during construction period:** Income/ expenses arising during construction of an item of PPE through associated or incidental operations are also to be assessed for capitalisation. The guiding principle in such cases is to assess whether or not such associated or incidental operations are necessary to bring that asset to the location and condition necessary for its intended use. For example, net proceeds on the sale of samples, manufactured during test runs while preparing a production machine for use, should be offset against the cost of the machine. In other words, the cost of these test runs less the associated income, are part of the cost of that machine. On the other hand, if, for example, a company acquired land in a key location with the intention of building its offices on that land, and until the company starts construction and obtains the necessary permits and the site is leased out. In this case, it could be argued that such associated or incidental operations are not necessary to bring the asset to the location and condition necessary for its intended use and thus the related income and expenses of these incidental operations will be recognised in the statement of profit and loss.

- **Feasibility study:** Cost of conducting a feasibility/ viability tests with respect to an item of PPE or a group of items of PPE to assess if they should be acquired cannot be capitalised even the item(s) are eventually procured by the company. Another example of non-capitalisable cost could be, professional fee paid (or internal costs incurred) by an entity to assess the cost savings that it could achieve by the use of certain machinery.

- **Costs incurred post an asset reaches its intended use:** Costs incurred after an item of PPE is in the location and condition necessary for it to be capable of operating in the manner intended by management, are not included in the cost of that item. For example, after the installation of a new item of PPE or after the construction of a new manufacturing facility, entities often incur cost for training the employees. Such costs, though essential for running the factory/using the item of PPE, cannot be said to be attributable to the construction/procurement of the PPE. Similarly, when



new uses are identified for an existing machinery in the form of new products that can be manufactured by the company with the use of such existing machinery, research cost and training cost for the same are not capitalisable.

- **Demolition costs:** In certain cases, government regulations require certain rehabilitation expenditure to be incurred by the company in case of infrastructure projects that significantly impact the location and/or the inhabitants of the area. Such expenditure could be in the form of contributions to certain government funds created for the purpose of rehabilitation/reforestation, construction of schools/training centers/hospitals/ residential units, expenditures for training in self-employment, etc. Such expenditure is a consideration for undertaking the project and/or land acquired for the project. Expenditures incurred for rehabilitation programmes are considered to be directly attributable and should be capitalised.

- **Abnormal costs:** Directly attributable expenditure would not include abnormal amounts of wasted material, labour, or other resources incurred and such costs should be recognised as an expense in the statement of profit and loss as they arise.

Component accounting

Each part of an item of PPE with a cost that is significant in relation to the total cost of the item should be depreciated separately.

This requirement is commonly known as 'component accounting'. Companies need to identify and depreciate significant components with different useful lives separately. The identified parts should be grouped together if they have the same or similar useful life for the purpose of separate depreciation. Insignificant parts may be combined together in the remainder of the asset or with the principal asset. Identification of separate parts of an asset and determination of their useful life is not merely an accounting exercise; rather, it involves technical expertise. Hence, a company may involve technical experts to determine the significant components of an asset.

For example, in a retail outlet, leasehold improvements at the outlet may include the air conditioning system and ducts (assuming the lease is for a period more than 10 years). As a practice, the company renovates the outlet every five years and thus all leasehold improvements (except air conditioning ducts) and furniture with respect to the outlet is depreciated over the period of five years. However, it is noted that the air conditioning system and ducts may have a useful life of 10 years. In the given case, the air conditioning system and ducts should be recognised as a separate component with a useful life of 10 years.

In case of a wind energy generation company, the wind turbines, transmit ion lines, sub-station, internal roads, etc. may all have separate useful life and might be needed to be capitalised as separate components with different useful lives.

Major inspections and overhauls are identified and accounted for as a separate component if that component is used over more than one period. If a major inspection or overhaul cost is embedded in the cost of an item of property, plant and equipment, then it is necessary to estimate the carrying amount of the component. The carrying amount of the component is determined with reference to the current market price of such overhauls and not the expected future price. Component accounting for inspection or overhaul costs is intended to be used only for major expenditure that occurs at regular intervals over the life of an asset. Costs associated with routine repairs and maintenance are expensed as they are incurred. Ind AS is silent about the specific costs that should be included in measuring the component attributable to major inspection or overhaul costs - i.e. whether they should be incremental and/or external costs. It seems that the cost of a major inspection or overhaul includes internal as well as external costs, and there is no requirement for the costs to be incremental.

The determination as to whether a part of an asset is significant requires a careful assessment of the facts and circumstances. This assessment would include at a minimum:[1]

- Determination of the threshold value to determine which asset requires componentisation
- Threshold value in percentage of cost of component to the total cost of the asset
- Proportion of useful life of that part as compared to the useful life of the asset
- Potential impact on the total depreciation expenditure.

For the purpose of determining the cost of such a component, the following criteria can be used in the order given below:

- Break-up cost provided by the vendor
- Cost break-up given by internal/external technical expert
- Fair values of various components, or
- Current replacement cost of component of the related asset and applying the same basis on the historical cost of asset.

1. Guidance from Guidance note on accounting for depreciation in companies in the context of Schedule II to the Companies Act, 2013 issued by Institute of Chartered Accountants of India on 7 October 2016.

Consider this:

- Income/expense from associated or incidental operations during construction period to be assessed on a case to case basis
- Abnormal costs incurred are to be charged to the statement of profit and loss as and when incurred
- Each part of PPE that has significant cost in relation to the item of PPE to be depreciated separately
- Identification of separate parts could be done with the help of technical experts
- Allocation of costs to various components requires judgement and estimation.