Common Errors – Property, Plant and Equipment

Dean Ardern

Thursday 14 September 2023

Wolters Kluwer

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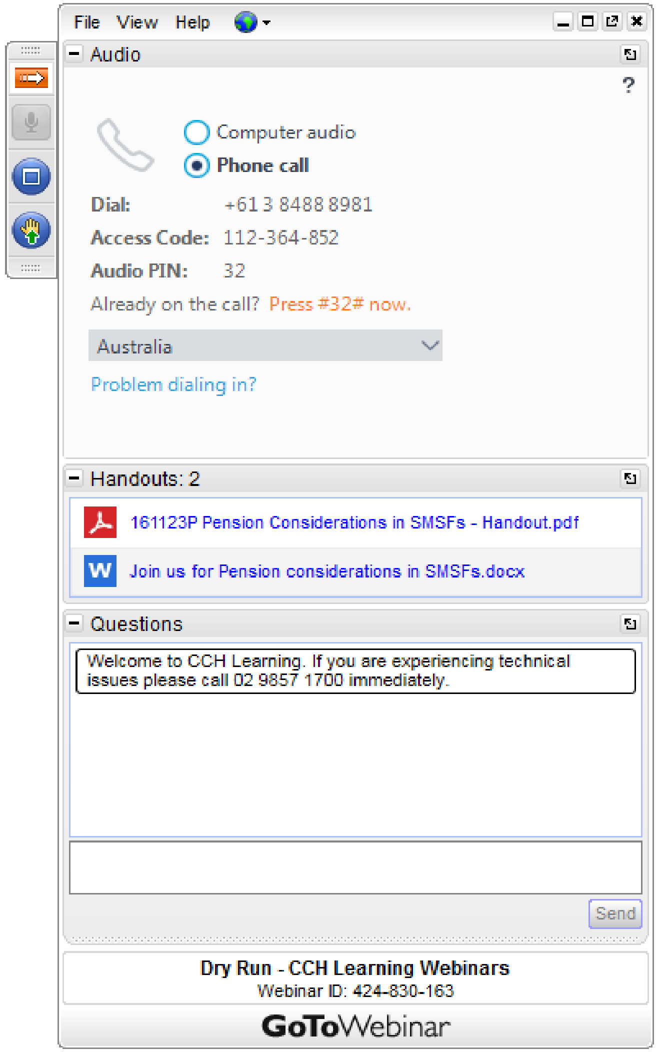
How to participate today



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Questions?

Alison Wood
Moderator

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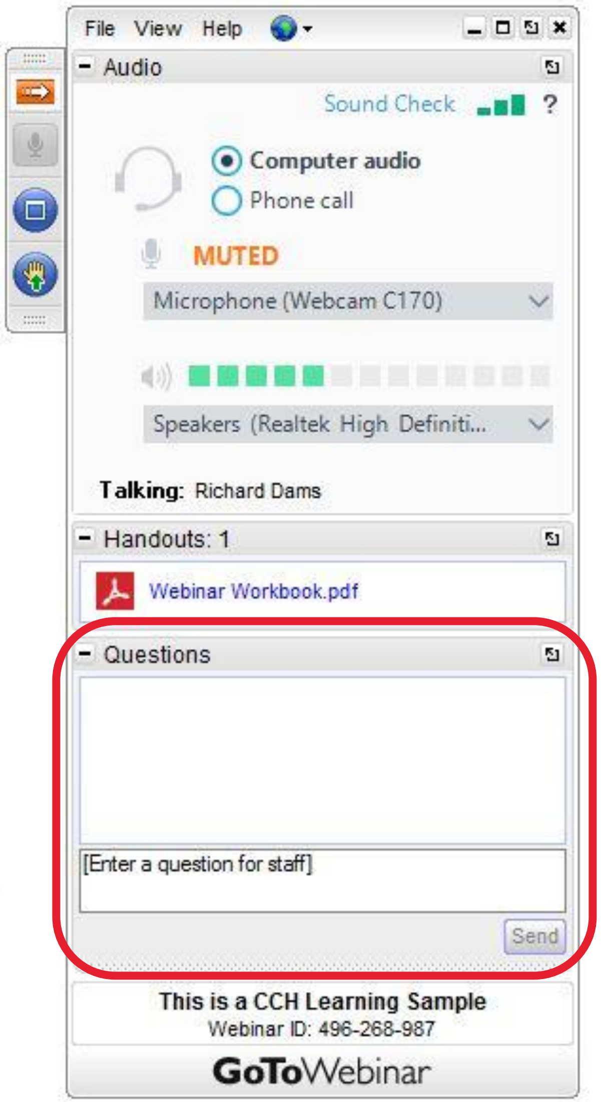

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Your Presenters

Dean Ardern

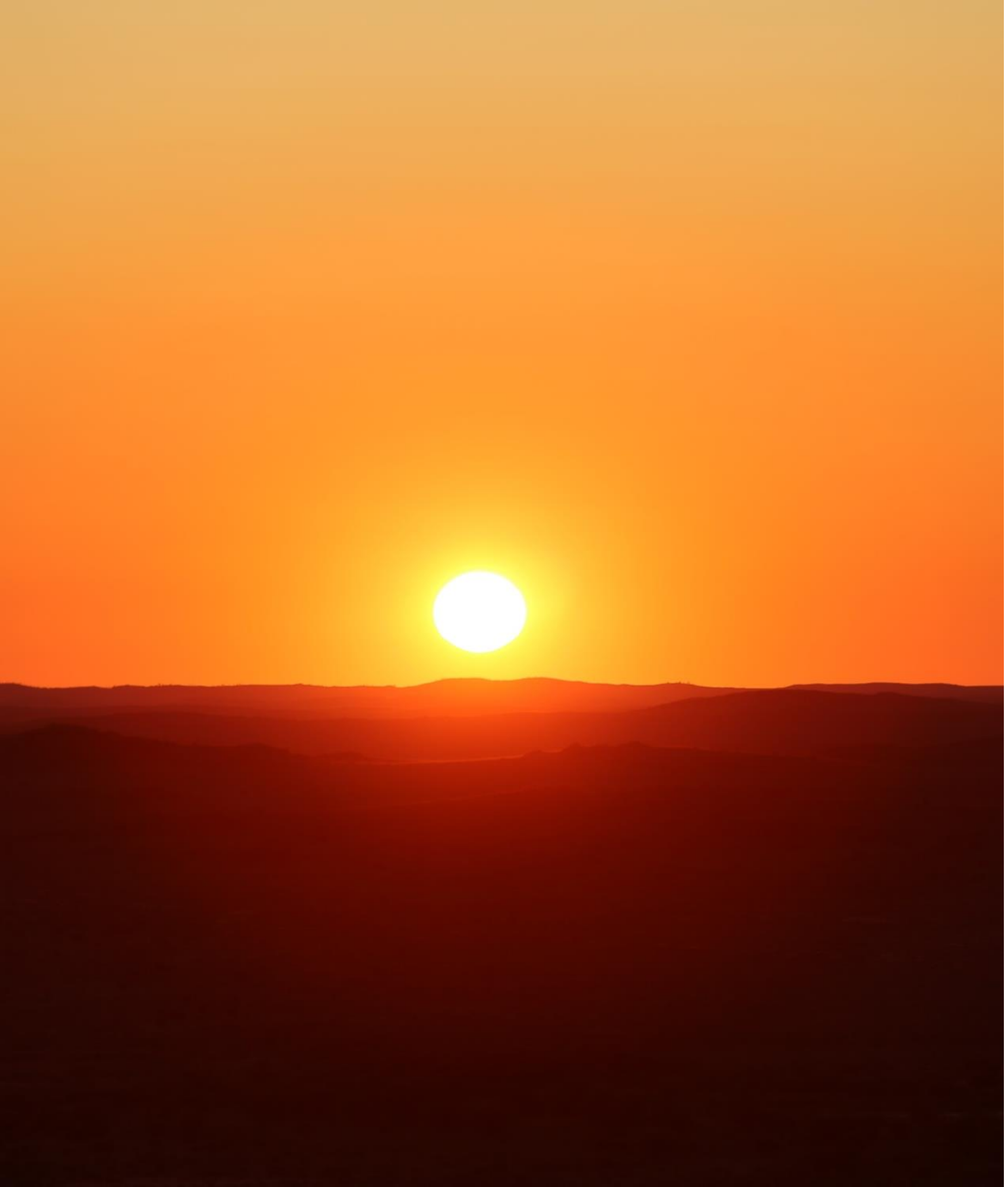
Director
IFRS & Corporate Reporting

BDO Australia

Today's session will cover

Common Errors – Property, Plant and Equipment

- Introduction to IAS 16
- Definitions, Scope & Initial Recognition Criteria
- Initial Measurement
- Issues that Arise on Initial Measurement
- Subsequent Accounting
- Issues that Arise During Subsequent Accounting
- Depreciation
- Issues that Arise Around Depreciation



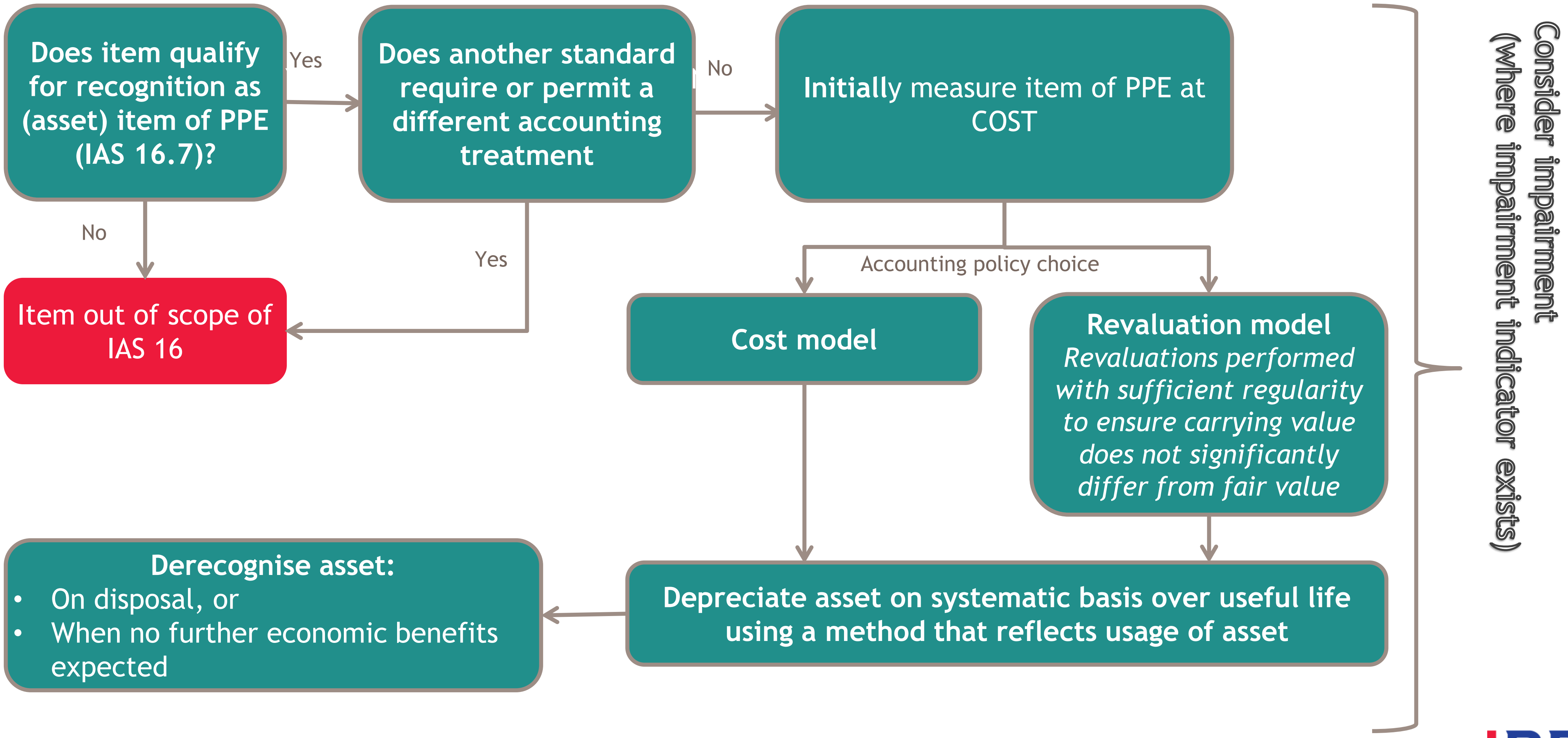
ACKNOWLEDGEMENT OF COUNTRY

We would like to begin by acknowledging the Traditional Owners of the land on which we meet today, and pay our respects to Elders past, present, and emerging.

We extend that respect to Aboriginal and Torres Strait Islander peoples here today.

INTRODUCTION

INTRODUCTION
Overview



DEFINITION, SCOPE AND INITIAL RECOGNITION CRITERIA

IDEAS | PEOPLE | TRUST

DEFINITION

What is property, plant and equipment?

- Property, plant and equipment are tangible items that:
  - Are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and
  - Are expected to be used during more than one period [IAS 16.6]

- PPE is recognised as an asset (at its *cost*) if:
  - The item meets the definitional criteria in IAS 16.6, and
  - It is probable that future economic benefits associated with the item will flow to the entity, and
  - The cost of the item can be measured reliably [IAS 16.7]

INITIAL RECOGNITION & MEASUREMENT

Cost of a self-constructed asset

Inventory or PPE?

- Inventories are assets:
  - Held for sale in the ordinary course of business
  - In the process of production for such sale, or
  - In the form of materials or supplies to be consumed in the production process IAS 2.6]

- PPE are tangible items that:
  - Are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and
  - Are expected to be used during more than one period [IAS 16.6]

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INITIAL RECOGNITION & MEASUREMENT

Spare parts, servicing and stand-by equipment

Spare parts, servicing equipment, stand-by equipment etc

- Recognised as PPE where they meet definition of PPE
- Otherwise recognised as inventory

Example

- Entity E owns and operates an electricity network and has just completed construction of a new electricity power station
- The power station consists of six turbines
  - Four to be used for electricity production
  - Two in the event any of the first four turbines break down
- The two turbines constructed as ‘stand-by’ equipment meet the definition of PPE, therefore recognised as PPE by Entity E

SCOPE

Overview

- IAS 16 applies to accounting for all items PPE except when another Standard requires or permits a different accounting treatment, such as:
  - IFRS 16 *Leases*
  - IAS 40 *Investment Property*
- IAS 16 does not apply to:
  - PPE classified as held for sale in accordance with IFRS 5
  - Biological assets related to agricultural activity (IAS 41)
  - Recognition and measurement of exploration and evaluation assets (IFRS 6)
  - Non-regenerative resources such as mineral rights and mineral reserves (e.g. oil, natural gas etc)
- IAS 16 does apply to PPE used to develop or maintain above assets

AUSTRALIAN-SPECIFIC SCOPE EXCLUSIONS

Properties held by not-for-profit entities

In respect of not-for-profit entities, property may be held to meet service delivery objectives rather than to earn rental or for capital appreciation. In such situations the property will not meet the definition of investment property and will be accounted for under AASB 116, for example:

(a) property held for strategic purposes; and

(b) property held to provide a social service, including those which generate cash inflows where the rental revenue is incidental to the purpose for holding the property. (AASB 140.Aus9.1)

- NFPs that use property to meet service delivery objectives as opposed to rental and/or capital appreciation purposes will always be required to account for the property under AASB 116. Such properties include:
  - Held for strategic purposes (ie, specific future use yet to be determined)
  - Property that is rented out but where the rental revenue is incidental. For instance, where the NFP also receives significant government grants to provide additional services to the renters

COMMON ERRORS

What could possibly go wrong?

- Distinguish between arrangements where an entity has legal title to the PPE and where it has a right to use (ie, lease)
- How do I account for land that might be used in the future for production or supply of goods or services, but management hasn’t yet determined what the actual purpose will be?
- How does an entity account for property that it owns and:
  - Operates as a hotel?
  - Rents to a third party who operates the property as a hotel?
- NFP entities accounting for property held to meet service delivery objectives as investment property

INITIAL MEASUREMENT

INITIAL RECOGNITION & MEASUREMENT

When is PPE recognised (on the balance sheet)?

- PPE is recognised as an asset (at its *cost*) if:
  - The item meets the definitional criteria in IAS 16.6, and
  - It is probable that future economic benefits associated with the item will flow to the entity, and
  - The cost of the item can be measured reliably [IAS 16.7]

INITIAL MEASUREMENT

Initial measurement

What is cost?

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, e.g. IFRS 2 *Share-based Payment* [IAS 16.6]

INITIAL MEASUREMENT

Elements of cost

Elements of cost

- Purchase price
- Directly attributable costs
- Initial estimate of costs to restore site of asset

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INITIAL MEASUREMENT

Elements of cost – purchase price

Purchase price

- The asset's purchase price
- Import duties
- Non-refundable purchase taxes
- Rebates and trade discounts are deducted

INITIAL MEASUREMENT

Elements of cost – directly attributable costs

Directly attributable costs

- Costs of employee benefits arising directly from the construction or acquisition of the 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
- Professional fees

INITIAL MEASUREMENT

Elements of cost – restoration costs

Initial estimate of costs to restore site of asset

- The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located
- The obligation to dismantle, restore or remove items is incurred when the item is acquired (i.e. in a contract such as a lease) or as a consequence of having used the item during a particular period

INITIAL MEASUREMENT

Examples of costs that are not capitalisable to PPE

- Costs of opening a new facility
- Costs of introducing a new product or service
- Advertising
- Promotional activities
- Costs of conducting business in a new location or with a new class of customer (including staff training)
- Administration and other general overhead costs
- Repairs and maintenance
- Research to choose which asset to acquire
- Cost of raising borrowings
- Cost of raising equity

INITIAL MEASUREMENT

Elements of cost

Costs ‘hidden’ in PPE purchase contracts

- Service costs included in a purchase contract for PPE should not be capitalised, including costs relating to:
  - Training
  - Maintenance

INITIAL RECOGNITION & MEASUREMENT

PPE acquired using deferred consideration

- The cost of an item of PPE acquired is the cash price equivalent at the recognition date
- If payment is deferred (more than normal credit terms) the interest is expensed over the period unless it should be capitalised in accordance with IAS 23 Borrowing Costs (i.e. on a qualifying asset)
- Interest is calculated as the difference between the cash price equivalent and the total payment

INITIAL RECOGNITION & MEASUREMENT

Government grants

Government grants relating to the acquisition of PPE be recorded as either:

- A reduction to the cost of the asset, or
  - Recognise in P/L as reduction to depreciation expense
- Deferred income
  - Recognise in P/L on a systematic basis over the life of the asset

INITIAL MEASUREMENT

Ceasing recognition of costs

- Cease recognising costs of an item of PPE when it is in the location and condition necessary for it to be capable of being operating in the manner intended by management
- Costs associated with redeploying an item of PPE are not eligible for capitalisation
- When an entity ceases to recognise initial costs = commence depreciation

ISSUES THAT ARISE ON INITIAL MEASUREMENT

COMMON ERRORS

What could possibly go wrong?

- Capitalising costs to PPE that don’t qualify for capitalisation (e.g., costs of moving operations to a new location, administration and general overheads, repairs and maintenance, training and future maintenance)
- Not recognising a ‘make good’ provision when the entity has an **obligation** to dismantle, restore or remove items (e.g., entity has a lease over a factory and at the end of the lease it needs to remove all of the equipment, furniture, fittings etc and return the factory back to a concrete shell)
- Continuing to capitalise costs after the item of PPE is in the location and condition necessary for it to be capable of being operating in the manner intended by management

OTHER COMMON ERRORS

Cost of a self-constructed asset

- Determined using the same principle as for an acquired asset
- Where similar assets are made for sale to external parties in the normal course of business, the cost is usually the same as the cost of constructing the asset for sale (i.e. the cost in accordance with IAS 2)
- Where the entity finances the construction of the asset using borrowings, the requirements of IAS 23 *Borrowing Costs* need to be considered as borrowing costs must be capitalised as part of the cost of the asset where recognition criteria is met
- Principles apply where entity contracts construction to a third party

OTHER COMMON ERRORS

Componentisation

- An entity needs to separately recognise each component (part) of an item of PPE that is acquired that:
  - Has a cost that is significant in relation to the total cost of the item
  - Has a different useful life
- So that each component acquired can be separately depreciated [IAS 16.43]
- Important considerations in determining whether repairs or maintenance
- Requires judgement

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OTHER COMMON ERRORS

Pre-production income earned

- Income earned by entity prior to an item of PPE being brought to the location and condition necessary to be capable of operating in the manner intended by management
- IASB Amendments to IAS 16 – *Property, Plant and Equipment - Proceeds before Intended Use (Amendments to IAS 16)* (effective from 1 January 2022)
  - Items may be produced while bringing an item of PPE to the location and condition necessary for it to be capable of operating in a manner intended by management
  - Examples include samples produced when testing whether the asset is functioning properly
  - Proceeds from selling such items, and the costs of those items, are recognised in profit or loss in accordance with applicable accounting standards

SUBSEQUENT ACCOUNTING

SUBSEQUENT COSTS

Repairs, maintenance or enhancements

Subsequent costs to an item of PPE are:

- Capitalised if it meets the recognition criteria in IAS 16.7
  - It is probable that future economic benefits associated with the item will flow to the entity, and
  - The cost of the item can be measured reliably
- All other items should be expensed
  - Examples of items that would be considered repairs and maintenance

SUBSEQUENT COSTS

Repairs, maintenance or enhancements

Subsequent costs associated with an item of PPE

Capitalise
If costs meet recognition principle
(IAS 16.7)

Examples:
- **Major inspections / overhauls**
- **Replacement required at regular intervals**
  - Relining furnace after certain number hrs
- Enhancements
  - **Re-fit of aircraft interiors**
  - Office re-fit
- **Separate component replaced**
  - E.g. replacement of truck engine, where body of truck and engine were two separate components

Expense
If recognition principle not met

Examples of items that maintain assets current economic benefit:
- Cleaning
- Day-to-day servicing (i.e. replacement of oil, missing screws or other small parts etc)
- Replacement of significant part maintaining benefit of PPE to entity
  - E.g. replacement of truck engine where entire truck was originally recognised as one component

SUBSEQUENT MEASUREMENT

Measurement after initial recognition

Initial Recognition
at Cost
(IAS 16.15)

Accounting
policy choice
applied to each class of PPE

Cost Model
(IAS 16.30)

Revaluation Model
(IAS 16.31)

SUBSEQUENT MEASUREMENT

Cost Model

After initial recognition as an asset, item of PPE carried at:

Cost Less Accumulated depreciation Less Accumulated impairment losses

SUBSEQUENT MEASUREMENT

Revaluation Model

After initial recognition as an asset, item of PPE carried at:

A revalued amount ***(fair value at date of revaluation)*** Less **Accumulated depreciation** Less **Accumulated impairment losses**

Revalue PPE with sufficient regularity to ensure carrying amount does not materially differ from fair value at the reporting date

AUSTRALIAN-SPECIFIC SCOPE EXCLUSIONS

Remeasurement of PPE by NFPs

Notwithstanding paragraph 39, in respect of not-for-profit entities, if the carrying amount of a class of assets is increased as a result of a revaluation, the net revaluation increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the net revaluation increase shall be recognised in profit or loss to the extent that it reverses a net revaluation decrease of the same class of assets previously recognised in profit or loss. (AASB 116.Aus39.1. See also AASB 116.Aus40.1)

Notwithstanding paragraph 40, in respect of not-for-profit entities, revaluation increases and revaluation decreases relating to individual assets within a class of property, plant and equipment shall be offset against one another within that class but shall not be offset in respect of assets in different classes. (AASB 116.Aus40.2)

- Like FPs, NFPs are required to recognise fair value revaluations in other comprehensive income (ie, equity), subject to the revaluations not reversing previously recognised fair value devaluations. However, unlike FPs, NFPs can offset fair value revaluations and devaluations within a class of assets, the effect of which is there will likely be less volatility due to fair value measurements in the balance sheets and profit or loss statements of NFPs

SUBSEQUENT MEASUREMENT

Revaluation Model

How to calculate the ‘fair value’ of item of PPE

- Fair value ‘is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date’ [IFRS 16.6]
- Refer to guidance in IFRS 13 Fair Value Measurement on how to determine fair value of item of PPE
  - Determine ‘highest and best use’ of asset
  - Valuation techniques
    - market approach
    - cost approach
    - income approach

SUBSEQUENT MEASUREMENT

Revaluation Model

Frequency of revaluations

- Valuation needs to be kept up to date
- Revalue with sufficient regularity so carrying amount at period-end not significantly different to fair value at period-end
  - More frequent – where class of PPE experiences volatile change in fair value (i.e. may need to revalue each year)
  - Less frequent – where class of PPE experience only insignificant changes in fair value (i.e. may only need to revalue every three to five years)
- Requires judgement

SUBSEQUENT MEASUREMENT

Revaluation Model

- Where item of PPE is revalued, entire *class* to which it belongs must be revalued

- A class of PPE is a group of assets similar in nature and use in an entity's operations, for example:
  - Land
  - Land and buildings
  - Machinery
  - Ships
  - Aircraft
  - Motor vehicles
  - Furniture and fixtures
  - Office equipment

Note that the following are not criteria for determining asset class:

- Geographical location
- Products and/or services produced by PPE
- Cost
- Quality/future service potential

ISSUES THAT ARISE DURING SUBSEQUENT ACCOUNTING

COMMON ERRORS

What could possibly go wrong?

- Incorrectly capitalise costs that are for repairs and maintenance and/or expense costs for enhancements that qualify for capitalisation
- In applying the revaluation model:
  - Using an income approach (or cost approach) when comparable market sales data is available (multiple fair value measurement techniques are often applied)
  - Assuming the current use is the highest and best use (particularly relevant to land and buildings)
  - ‘Double counting’ additions to fittings, fixtures, etc as part of fair value remeasurement (ie, booking an enhancement to the asset account and then not adjusting the end of year fair value increment for the enhancement)
  - Allocating items of PPE to the wrong asset class (including excessive aggregation of PPE items). For instance, buildings and land should be fair valued separately
  - Not remeasuring PPE on the revaluation model sufficiently frequently in the context of changing economic conditions

SUBSEQUENT MEASUREMENT

Revaluation Model

Where **Fair Value** Materially different to **Carrying Value** Then **Item of PPE must be revalued**

DEPRECIATION

DEPRECIATION

Definitions

Depreciation

- Is the systematic allocation of the depreciable amount of an asset over its useful life [IAS 16.6]

Depreciable amount

- Is the cost of an asset, or other amount substituted for cost, less its residual value [IAS 16.6]

DEPRECIATION

Definitions

Residual value

- Of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life [IAS 16.6]

Depreciable amount

- The period over which an asset is expected to be available for use by an entity; or
- The number of production or similar units expected to be obtained from the asset by an entity [IAS 16.6]

DEPRECIATION
Components

- Each part [component] 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 [IAS 16.43]
- On initial recognition, each component needs to be separately recognised so it can be depreciated based on the part's useful life
- Grouping of items permitted with similar useful life and depreciation method
- Where entity recognises cost of replacement part as part of carrying amount of PPE, the replaced part must be derecognised regardless of whether the part had been separately depreciated
- Requires judgement

DEPRECIATION

Commencement of depreciation

- Depreciation of an asset (with a limited useful life) begins when the asset is available for use
  - When asset is in location and condition necessary for it to be capable of operating in the manner intended by management – i.e. at the same point that costs cease being capitalised
  - Assets should be depreciated regardless of whether the asset is in use or idle
  - Note: where usage method used to calculate the depreciation charge, it will be zero when there is no production

DEPRECIATION
Cessation of depreciation

- Items of PPE, whether held under the cost or revaluation models, need to be depreciated on a systematic basis over its useful life, except for:
  - Items of PPE that have an unlimited life – i.e. land
  - Investment property accounted for using the fair value model under IAS 40 *Investment Properties*

- Depreciation ceases the earlier of:
  - The date the asset is classified as held for sale in accordance with IFRS 5, or
  - The date the asset is derecognised

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DEPRECIATION

How should items be depreciated?

Fair value of asset ≥ Assets carrying amount = Depreciation recognised

Unless

Assets residual value ≥ Assets carrying amount = Depreciation not recognised

DEPRECIATION
Useful life

- The entity should consider the following factors when estimating the useful life of an asset:
  - Expected use
  - Physical wear and tear
  - Technical or commercial obsolescence
  - Legal or similar limits
- Useful life vs. economic life of asset
- Land generally not subject to depreciation as it does not have a limited useful life (leased land subject to depreciation)

DEPRECIATION

Useful life

- The entity is required to review the residual value and useful life of an item of PPE at least each year
  - Intended use of the item of PPE is important, not the second hand value
- If expectations differ from previous estimates then the changes are accounted for as a change in accounting estimates in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
- Changes are accounted for prospectively
  - I.e. the undepreciated amount at the date of the change in the estimate of the useful life is depreciated over the revised estimate of the assets useful life

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DEPRECIATION

Leased assets

Leasehold improvements

- Should leasehold improvements be depreciated over:
  - The lease term, or
  - The useful life of the leasehold improvements

- IFRS 16 does not directly deal with this situation

DEPRECIATION
Depreciation method

- The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity [IAS 16.60]
- Depreciation methods include:
  - Straight-line – constant charge over assets useful life
  - Diminishing balance – decreasing charge over assets useful life
  - Units of production – charge based on expected use or output
- Depreciation method is subject to review at each financial year-end. Where there has been a significant change in expected pattern of use, depreciation method changed prospectively in accordance with IAS 8

ISSUES ARISING FROM DEPRECIATION OF PPE

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COMMON ERRORS

What could possibly go wrong?

- The depreciation method used does not reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. For instance, straight-line method is used but:
  - Most of the economic benefits will be received during the earlier periods of the asset's useful life, or
  - The asset has an unlimited life if not used but it's useful life reduces proportionately as usage increases
- The depreciation method applied is based on revenue that is generated by an activity that includes use of an asset (prohibited under IAS 16.62A)
- Inputs to the depreciation calculation are not reviewed annually (as required under IAS 16), resulting in:
  - Useful life becoming over- or under-estimated
  - Residual value becoming over- or under-estimated

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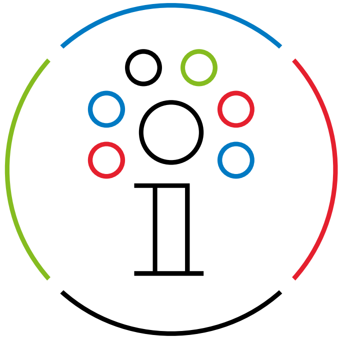
Questions

You can type them in the “Questions” box now

Or contact me via:



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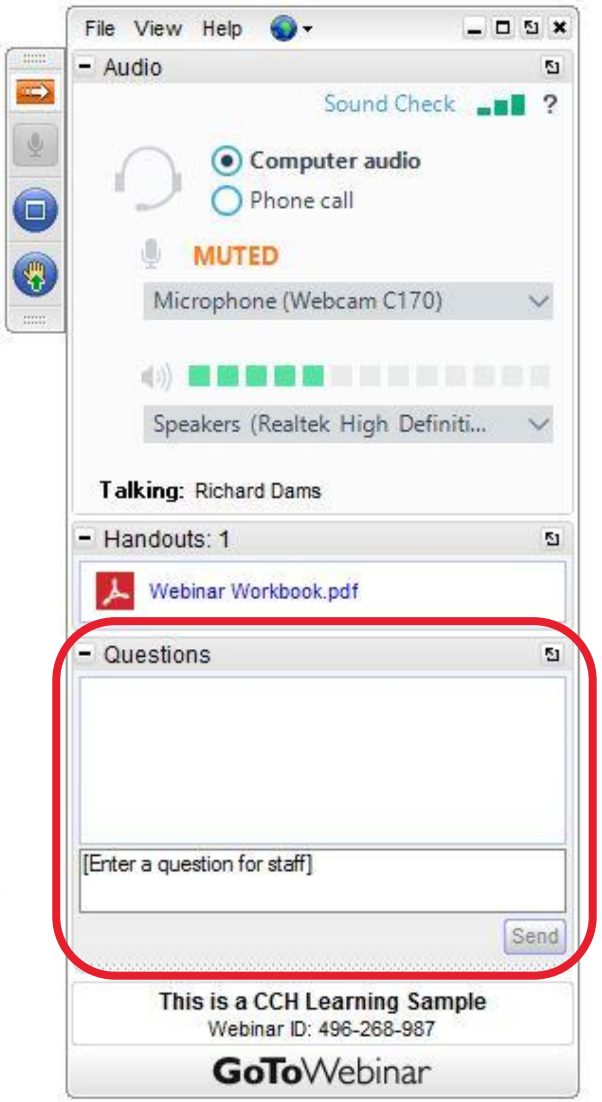
Questions?

Alison Wood
Moderator

Type your question and hit Send



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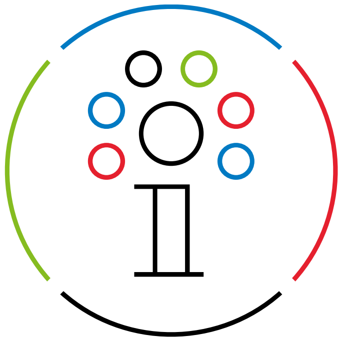

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- 19 September – Psychosocial Safety and Risk Management in the Workplace
- 20 September – SMSF Strategies for 2024: Getting the most from your clients SMSF
- 21 September – Tax Practitioners Board – What Agents Need to Know
- 26 September – Tax Technical Update – September 2023
- 03 October - Cyber Security Update - October 2023

Questions

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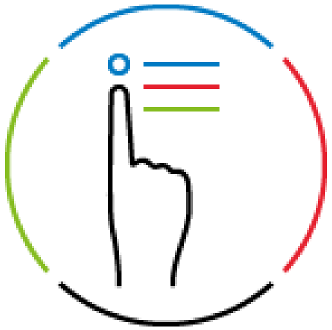

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