Resolving Accountants' Dilemma in Capitalising Costs

Ind AS 16 and AS 10, Property, Plant and Equipment, that are applicable to respective class of companies, whereas the AS 10 of ICAI applies to non-corporates, which are almost in sync with each other and deal with the property, plant and equipment, are among the most important items in the balance sheet of business enterprises. Indeed, the broad principles of capitalisation of costs of fixed assets did not see any material change after the advent of the era of Accounting Standards except for some refinements in the understanding of principles of capitalisation of fixed assets. In this article, while discussing the accountants' dilemma in capitalising costs, the author steers through various concepts including major principles in capitalising costs and explains costs in case of exchange of assets, major spare parts, subsequent cost, exclusion of costs, replacement of major parts, and dismantling costs, and explains the accountants' perspectives in the case. Read on…

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Ind AS 16 and AS 10, Property, Plant and Equipment, both issued under the Companies Act and AS 10 of ICAI, are almost in sync with each other. The former two are applicable to respective class of companies, whereas the third one applies to non-corporates. These Standards deal with the property, plant and equipment (PPE), among the most important items in the balance sheet of business enterprises.

Indeed, the broad principles of capitalisation of costs of fixed assets did not see any material changes after the advent of the era of Accounting Standards except for some refinements in the understanding of principles of capitalisation of fixed assets. The concept of *components accounting* was not an innovation in the Accounting Standards but acceptance of the relevance of the practiced concept by the accountants of major enterprises.

As per the above Standards, an item falls under the definition of PPE, if it is a tangible item, and *held for use* in the production or supply of goods or services or for rentals to others or for administrative purposes and are expected to be used during more than one period. The above definition under Ind AS 16, defines *specific purposes of use* which suffers from infirmities. An enterprise, which uses a PPE like computers for promotion of its products by designing advertisement materials or uses vehicles exclusively for road shows of its products all of which constitute *marketing activities*, can argue that such items are not covered under PPE in the Ind AS 16. Similarly, equipments bought for research purposes or computers bought for accounting are not in the defined purposes of use in the PPE definition. To argue that those purposes are covered under *administration* would be stretching it too far. So, one expects the infirmities could be set right only by broadening the definition by including residual use.

Further, an enterprise which closes its accounts every three months buys steel of six-month requirement, which is used in the production of motorcars. If we apply literally, the definition of PPE under Ind AS 16, the above item of steel is to be capitalised and depreciation charged at the end of the 3-month period. But it would look absurd from the point of generally-known accounting principles.

Ind AS 16 requires amendments to clarify its position. The definition of PPE also requires more refinement so as to make it clear that the tangible items or assets, which are held for sale in the normal course of business or for consumption qualifies to be classified as inventory under Ind AS 2, but do not qualify as PPE.

Major Principles in Capitalising Costs

The main principles that apply in capitalising the costs of a *fixed* asset is that it includes its *purchase price* net of discounts, tax rebates and costs directly attributable in bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by the management. Also, initial estimates of dismantling costs under certain situations are to be capitalised. In practical situations, doubts would arise whether a particular cost forms part of the cost of an asset or not. In all such cases, we should test the expenditure based on the above principle.

For example, an entity constructs a factory building and in order to use the building, it requires certain statutory clearances like *environment clearance, fire safety*, and occupation certificates. The question is whether such expenses can be capitalised as a part of building costs. The answer is yes, since the factory building cannot be put in to intended use without incurring such costs.

It is possible that *fire safety* certificate is to be renewed at periodic intervals - may be annually or once in five years or so on. In such cases, such renewal costs are charged off to revenue. For instance, when an entity capitalises a machine, the cost of machine includes *inter alia* numerous small parts like screws, nuts, bolts, etc. But when replacement of those small parts are made, the same is charged off to revenue. This is because it is not practical to remove the book value or carrying cost of such small parts and capitalise the costs of new small parts. Such an exercise is reserved for major components. Similarly, in case of periodic renewal costs of fire safety certificate also, the same is charged to revenue.

Further, if an entity has to obtain a factory license or permit, could the cost of obtaining the license be capitalised as a part of cost of the factory building in the above case? The answer is *no*. The use of place as a factory means not only the use of building but also the plants erected thereon, machines, equipments and other facilities together with the human resources employed therein. In other words, the license or permit is required to commence production operations. Such expenses fall under the definition of *expenses* as contained in the *framework to Accounting Standards*.

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The reasoning to capitalise *specific major spares* seems to be that a major spare part has a substantial cost to it and its life cannot be beyond the life of a fixed asset for which alone it can be used. Further, irrespective of its use, it suffers depreciation loss over a period of time due to a passage of time.

In case the license fee or permit fee is paid once in five years, the payment related to the subsequent four years are treated as asset as per the definition of *asset* in the *framework*. In case of vehicles like buses, trucks, cars, etc., the vehicles cannot be put in to intended use unless the vehicle registration is obtained. Hence, those costs also form part of the cost of relevant vehicle. However, insurance costs for building, vehicles, etc., are charged to revenue. This is because the insurance of building or vehicles is a voluntary management decision in order to protect from unexpected risks and without insurance, the building or vehicles can be put into use. Hence, it qualifies as *expenses* under the *framework*. As per Ind AS 16, inclusion of costs as part of an asset ceases the moment the asset is brought to the location and condition necessary for it to be able to operate in the manner intended by the management. So, costs incurred in using an asset or redeploying an asset is not included in the carrying cost.

To cite some examples, we may say, like costs incurred while the asset is ready for use after installation, erection and commissioning— but the machine is not operated due to lack of orders but insurance, servicing costs are incurred, initial operating losses when an asset is used sub optimally in the initial period and costs in relocating an asset.

Further, as per Ind AS 16, costs and income are not recognised as part of capitalising an asset, if it relates to operations either before or during construction or development of an asset that are not required in bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by the management, like rent realised on a vacant land on which a building is yet to be built.

Cost in Case of Exchange of Assets

Under Ind AS 16, the broad principle is when an asset is acquired in exchange for another, it shall be taken at the fair value of the asset acquired or given up which is more clearly visible. As per Ind AS 16, if the acquired asset is not measured at fair value, it is measured at the book value of the asset given up.

Major Spare Parts, etc.

The criterion as per Ind AS 16 is:

> *"Spare parts and servicing equipment are usually carried as inventory and recognised in profit or loss as consumed. However, major spare parts, stand-by equipment and servicing equipment qualify as property, plant and equipment when an entity expects to use them during more than one period."*

There is a lacuna in the above. Indeed, it should be the case that major spare parts specific to an asset only deserves capitalisation and other major spare parts which are general in nature needs to be treated as *inventory* as long as it is kept in stock and capitalised as *component costs*, as and when the items are used in the respective PPE, in line with the principles of Ind AS 16. The reasoning to capitalise *specific major spares* seems to be that a major spare part has a substantial cost to it and its life cannot be beyond the life of a fixed asset for which alone it can be used. Further, irrespective of its use, it suffers depreciation loss over a period of time due to a passage of time.

For example, spare engine bought for new-generation nuclear submarine, along with the purchase of the submarine, which can be used only in respect of the specific submarine needs to be capitalised along with the respective asset. Even if the spare engines are bought subsequent to the acquisition submarine say after five years, the same needs to be capitalised and written off during the remaining life of the main asset.

However, if major spares like Wings or Engines are bought which can be used for all AIR BUSES A 380 aircrafts with a life span exceeding more than one accounting period, it should not qualify for capitalisation as and when bought since such spares are general in nature. In case of General major Spares, capitalisation leads to charge of depreciation on such spares. This in turn would lead to an undercharge of spares value when actually consumed. The inherent principle of accounting is that costs should be accounted where it belongs.

The general major spares are to be capitalised along with the respective asset as and when used in that asset. Major general spares like wings falls under inventory since it is in the form of materials to be consumed in rendering services.

Subsequent Costs

As per Ind AS 16, subsequent costs incurred to add to an existing asset or replace a part of it or service an asset becomes cost of a fixed asset, provided it meets the criterion for capitalisation. So, if tyres of a motorcar are replaced it qualifies for capitalisation as with such a replacement, future economic benefits will flow to the entity in as much as replacement of the engine of a car. Traditionally, the former is treated as repairs and charged off, as it neither enhances the life of motorcar nor adds to its value significantly. However, under Ind AS 16, such items can be capitalised, but by considering the *principle of materiality*, the same shall be charged off.

There is difficulty in identifying improvement costs related to fixed assets that are to be capitalised and the costs that need to be charged to income account. Such costs that enhance the future benefits of an existing asset beyond its previously assessed standards of performance need to be capitalised like increase in capacity. Of course, expenses that result in improved quality of the products or services, or, results in lower rejections or lower maintenance costs of an asset or lower down time also qualify for capitalisation.

Further, if an improvement of an existing asset results in an independent asset that can be used even after the relevant asset is disposed off or discarded, *such an independent asset shall be capitalised* separately without merging it in the cost of an existing asset. The obvious reason being such an independent asset will be depreciated separately. Examples are like audio system or air conditioner in a bus or car, voltage stabilisers for appliances.

Exclusion of Costs

Further, Ind AS 16 states:

> "Examples of costs that are not costs of an item of property, plant and equipment are: costs of opening a new facility; costs of introducing a new product or service (including costs of advertising and promotional activities); costs of conducting business in a new location or with a new class of customer (including costs of staff training); and administration and other general overhead costs."

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The costs referred under (a) to (c) above are sometimes referred as *startup costs*. Ind AS 16 does not provide any example of the above which ought to have been done to make the descriptive part clear. However, costs of opening a new facility may include expenses incurred in choosing a location amongst the alternatives, costs incurred in discussions with agencies of government, potential investors, etc., costs incurred for evaluation of costs/benefit analysis of different locations, feasibility studies of alternative proposals, inauguration costs, publicity costs for opening new facilities all of which cannot be capitalised.

Costs of introducing a new product or service may comprise *inter alia* costs of free samples, product demos, introductory free services, customers communication costs, etc., which cannot be added to PPE. Costs of conducting business in a new location may refer to costs such as shifting of Machines/ Equipments to a New Location, One-time payment to employees to Shift to a New Location, etc.

Costs of conducting business with new class of customers may include costs of product samples, entertainment costs, travel costs, etc. The most important point is that administrative and other general overhead costs cannot be capitalised. In other words, office expenses of Board of Directors and other administrative officials/ staff, other general overheads like purchase department, accounts department costs cannot be capitalised. In a nutshell, all expenses which are indirect to a PPE, except factory overheads, are not to be added to PPE costs.

Replacement of Major Parts

Under Ind AS 16, cost of replacement of parts of property, plant and equipment (PPE) like replacement of the compressor of a refrigerator is also capitalised by applying the same principle for the main asset. However, the written-down value (WDV) of the part replaced shall be written off to income account, if it is identifiable or else shall be written off, based on the acquisition value of the new part. Also, certain assets require mandatory major inspections like an aircraft. In such cases, such services are capitalised and earlier major inspection service costs capitalised are derecognised or written off.

Under Ind AS 16, significant parts of an asset like engine of an aircraft shall be capitalised separately.

Dismantling Costs

Further as per Ind AS 16, 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" also forms part of the property, plant and equipment.

In other words, if an entity erects a machine whose useful life is estimated to be five years on a leased site, which lapses after five years and, as per the terms of the lease, the lessee has an obligation to restore the site to its original condition after the end of the lease period, the estimated dismantling and restoration costs shall be included in the cost of the plant for the purposes of capitalisation.

Alternatively, a plant erected in the entity's own premises which requires dismantling and restoration after the useful life of the plant; such costs also need capitalisation, since such costs are incurred as a consequence of having used the item during a particular period. *In both the above cases, the recognition of such costs in line with the Ind AS 16 shall be measured in line with Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets*.

Broadly, under the above Ind AS 37, if time value of money is material, provisions are to be made based on the present value of future cash outflows by using a pre-tax discount rate in line with the current market rates plus risk premium with respect to a particular liability. As per Ind AS 37, the discount rate shall not reflect risks for which future cash flows are adjusted. On the other hand, let us say a plant is dismantled for a temporary period of six months to a different location for production of specific goods at that location, such costs are treated as part of inventory costs in accordance with Ind AS 2 for the purpose of recognition of such costs and measured in accordance with Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*, since such costs are incurred to produce inventories during that period.

Traditionally, the dismantling/restoration of site costs are written off to income account, as such costs do not add any value to the concerned machine or plant or such other asset. Further, such costs arise after the use of the machine and do not form part of the asset cost. Such costs arise either due to third-party obligations or business decisions and, in either case, the prescription in the Ind AS 16 is to capitalise the same, while asset cost seems to be inappropriate.

Alternatively, a plant erected in the entity's own premises which requires dismantling and restoration after the useful life of the plant; such costs also need capitalisation, since such costs are incurred as a consequence of having used the item during a particular period. *In both the above cases, the recognition of such costs in line with the Ind AS 16 shall be measured in line with Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets.*

Firstly, it runs contrary to the principle laid down in the very same Accounting Standard to the effect that recognition of costs of a PPE ceases, when an item is at the location and condition necessary for it to be able to operate in the manner intended by the management. Since dismantling costs are incurred at a much later stage subsequent to the asset being put into intended use, the same do not qualify for capitalisation as per the above principle. Further, such costs do not add any value to the asset and by capitalising the same, the asset carrying cost gets inflated to that extent.

Secondly, either under the contractual terms or under the statutory regulations of a country, an entity cannot proceed to erect, commission and use certain plants (for example, nuclear plants, oil rigs, waste treatment plants, etc.), unless it accepts the liability for dismantling and restoration costs. Even in some cases, the entity may itself incur such costs on a voluntary basis in its own site or factory. In all these cases, the liability for dismantling costs confers an entitlement and benefit on the entity to put up a particular plant and facilities and use it during a future period. This entitlement/benefits are in the nature of intangible assets under Ind AS 38, as it is identifiable, controllable by an entity from which future economic benefits would flow to the entity.

Therefore, in cases where such costs are significant such as in nuclear plants, the best alternative is to create a provision for dismantling costs in the year of capitalisation of relevant asset, by recognising such costs as intangible asset under the head *dismantling and restoration costs* and amortising it over the useful life of the relevant PPE by a charge income account. ■