KCO BLOGS 2020

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IAS 16 PROPERTY PLANT & EQUIPMENT

This blog describes IAS 16 , this standard was first issued in 1993. It was re-issued in 2003 and applies to annual periods beginning on or after 1st January 2005. The latest amendment was done in May 2020.

IAS 16 describes the accounting treatment of Property plant and equipment. The main issues dealt with in this standard are primarily the following:

1) Recognition of PPE. When to recognize an asset.

2) Initial measurement. Determining the cost of the asset for capitalization.

3) Subsequent measurement. Treatment of an asset after its recognition and initial measurement.

4) Depreciation.

Let's look at the definition of PPE before discussing the above mentioned points.

Property plant and equipment are "**Tangible**" items that: *(quote)*

- ***Are held for use in production or supply of goods and services.***
- ***Are expected to be used during more than one period.***

Recognition of PPE:

This simply means that an item cost should only be recognized as an asset when: *(quote)*

- ***It is probable that the future benefits associated with the asset will flow to the entity.***
- ***The cost of the asset can be measured reliably.***

Initial measurement:

An item of PPE should initially be measured at its cost:

Include all costs incurred in bringing the asset to its working **location and condition.** Include costs such as **purchase cost**, **material cost, labor cost, site preparation cost, delivery cost, installation costs and borrowing cost.** An example of borrowing cost would be the **interest expense** paid on an item of PPE that was constructed or purchased by taking a loan.

Dismantling costs are simply the costs incurred **in removing PPE**. Suppose that a company decides to relocate its factory/production plant to another location, it will have to dismantle its plant and machinery first to move to another location. Take an example of an Oil rig, when the well dries up the company operating it dismantles its plant and machinery to move to another area. In some parts of the world there is sometimes a legal obligation to restore the site to its pre-operation condition, like on company operating a civil nuclear power plant.

It should also be noted that dismantling costs are **future costs**, therefore **a present value** of these costs should be capitalized and a liability should be setup in the accounts. The liability created in the accounts will have to be increased by the interest rate every year.

Students appearing in financial reporting exam should be able to calculate the Present value of dismantling costs. I will demonstrate it below with the help of an example:

EXAMPLE

Suppose if a company built an oil rig:
Cost of construction= **10 million $**
Dismantling cost at the end of its useful life of **20 years** = **4 million $**
As stated above the present value of this 4 million has to be calculated and for that we need an interest rate, let's say **5 %**
Calculation:
4,000,000*1/1.05(20) =1507558 $
The total amount to be capitalized in this case would be **10,000,000+1507558=11507558$**

Subsequent measurement:

This simply means how PPE should be treated after recognition and initial measurement. IAS 16 allows **two methods** for the purpose, which are:

- Cost model:
  This model is very simple. PPE should be valued at **cost less accumulated depreciation and any accumulated impairment losses.** An impairment loss occurs when an assets fair market value depreciates below its carrying value.

- Revaluation model:

  Under this model PPE can be carried at **a re-valued amount less any subsequent accumulated depreciation**. Certain conditions must be complied with if this model is chosen and they are as follows: *(quote)*

- ***Re-valuations must be made regularly to make sure that the carrying amount of PPE does not differ materially from the fair value at each reporting period.***
- ***When an item of property plant and equipment is re-valued, the entire class of assets to which the item belongs must be re-valued.***

If a re-valuation results in a **re-valuation gain**, it is taken to **profit and loss account** as **other comprehensive income** just like profit for the year is taken to retained earnings or accumulated fund.
Students appearing for financial reporting exam should be able to calculate gain and loss, their journal entries and their treatment in the financial statements.

Making a journal entry will clear any confusion:

Debit	Non-current asset (to increase the value of asset)
Debit	Accumulated depreciation (to eliminate acc. dep)
Credit	Other comprehensive income (re-valuation surplus)

Depreciation:

In general terms depreciation is a decrease in the value of an asset because of its usage and wear tear. Depreciation is continued even if the asset is not being used.
IAS 16 says: ***(quote)***

- ***It is the systematic allocation of the depreciable amount of an asset over its useful life.***
- ***Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.***

When IAS 16 says systematic allocation it means the method of calculating depreciation.

Depreciable amount is the cost of an asset minus its re-sale value. An example would be:
Cost **10,000 $ - 1,000 $** re-sale value **= 9000 $** depreciable amount.
This depreciable amount is then spread over the useful life of an asset

A few methods to calculate the depreciation for the year are as follows:

- Straight line
- Reducing balance
- Machine hours

Further details of this topic will be explained in my next blog.

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