

LKAS 16: Accounting for Property, Plant and Equipment

Introduction

A fundamental issue in financial reporting is how to account periodically for performance when much of the expenditure that an entity occurs in the current period contributes to future accounting periods as well. One such example is expenditure on Property, Plant and Equipment (PPE). In this context, this document focuses on a range of issues associated with accounting for PPE. In this respect, the following areas are covered in this chapter: definition; recognition; measurement; and disclosure of PPE with reference to LKAS 16: Property, Plant and Equipment.

Definition of Property, Plant and Equipment

LKAS 16 defines PPE as **tangible items that are held by an enterprise for use in the production or supply of goods or services or for rental to others or for administrative purposes and are expected to be used during more than one period.**

Examples for PPE:

- Office building
- Furniture in the office
- Manufacturing plant
- Equipment used in an office
- Motor vehicles used in distribution of goods
- Equipment held for the purpose of renting to others
- ATM Machine of a bank

The following are not PPEs.

- Land held for sale by a property development company, as it is classified as inventory
- Brand name, as it is not a tangible asset
- Non-current assets held for sale
- Stationery used in a bank, as it is classified as inventory

Recognition criteria for PPE

The cost of an item of PPE should be recognized as an asset only if:

- It is probable that future economic benefits associated with the asset will flow to the enterprise; *and*
- The cost of the item can be measured reliably.

Measurement of PPE

Measurement of PPE should be discussed under two stages, namely, measurement at recognition and measurement after recognition as indicated below.

(a) Measurement at Recognition

An item that qualifies to recognize as an asset should be measured **at cost**. The cost of an item of PPE comprises the following:

- Purchase price includes import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- Costs directly attributed to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by the management.
This includes.
 - * 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; *and*
 - * Professional fees.
- The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.

However, the following cost cannot be included in determining the cost of PPE.

- 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 customers (including costs of staff training)
- Administration and other general overhead costs.
- Costs that are 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.
- Initial operating losses, such as those incurred, while demand for the item's output builds up.
- Costs of testing whether the asset is functioning properly, (such as samples produced when testing equipment).
- Costs of relocating or reorganizing part or all of the entity's operation

(b) Measurement after Recognition

When PPE items are measured after recognition, an entity can choose one of the following two methods.

- Cost model or
- Revaluation model

Using either a cost model or revaluation model depends on the entity's accounting policy applicable to PPE. Further, the entity should apply that policy to the entire class of PPE. The following are examples for separate classes of PPE.

- Land
- Land and buildings
- Machinery
- Motor vehicles
- Furniture and fixtures
- Office equipment

Cost Model: PPE should be carried at cost less accumulated depreciation

Carrying amount = Cost – Accumulated depreciation

Revaluation Model: An item of PPE, whose fair value can be measured reliably, should be carried out at its revalued amount (fair value at the date of revaluation) less any subsequent accumulated depreciation.

Carrying amount = Revalued amount – Accumulated depreciation after the revaluation

Revaluation of PPE

PPE can be revalued to reflect their current values. The revaluation of assets should be carried out with sufficient regularity to ensure that their carrying amount does not differ materially from that which would be determined using fair value at the reporting date. The frequency of revaluations depends upon the changes in fair values of the items of PPE being revalued.

LKAS 16 allows assets to be revalued at their fair value. The fair value of an asset is usually determined based on its market value. The fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by a professionally qualified valuer. The fair value of other items of PPE is usually based on their market value determined by appraisal.

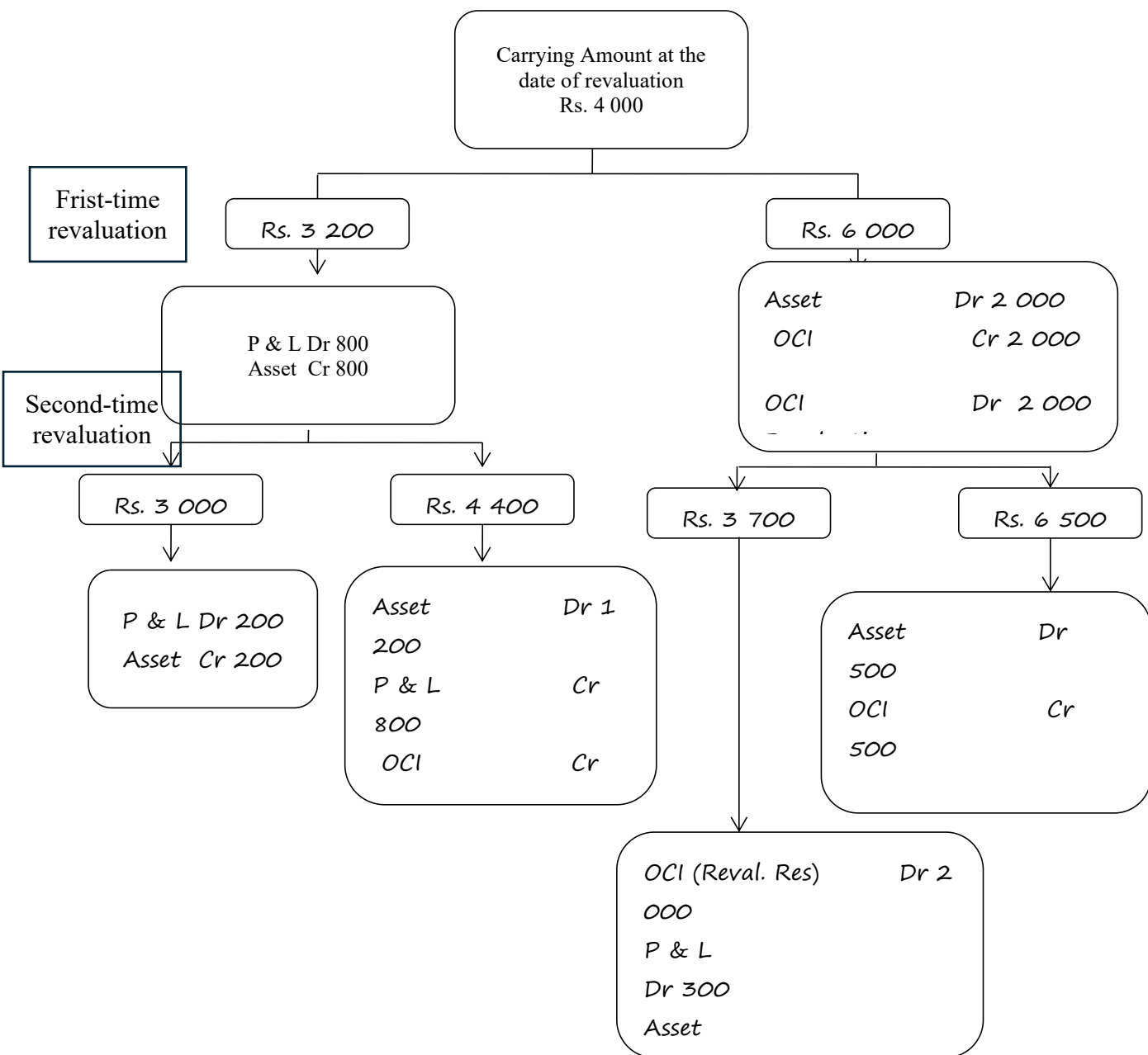
When an asset is revalued, its accumulated depreciation at the date of revaluation should be eliminated against gross carrying amount of assets.

Revaluation could result in either an upward or a downward revision of asset values and results in a revaluation surplus or deficit. The upward revision refers to the increase in the carrying amount of an asset as a result of a revaluation. The resulting surplus should be recognized in other comprehensive income and accumulated in equity under the heading revaluation surplus when there is no previous revaluation deficit. However, the surplus should be recognized in the profit or loss to the extent it reverses previously recognized revaluation deficit of the same asset in profit or loss.

On the other hand, the downward revision refers to the decrease in the carrying amount of an asset as a result of a revaluation. The resulting deficit should be recognized in profit or loss as an expense when there is no previous revaluation surplus. However, the deficit should be recognized in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of the asset.

The accounting entries for revaluation surplus or deficit of PPE under each of above-mentioned situations are depicted below.

Summary of accounting for revaluation surplus or deficit of PPE



Depreciation of PPE

Depreciation represents the recognition of the decrease in the service potential of an asset across time. It is defined in LKAS 16 as follows:

“Systematic allocation of the depreciable amount of an asset over its useful life”

The depreciable amount is defined as follows:

“The cost of an asset, or other amount substituted for cost, less its residual value.”

The residual value and the useful life of an asset should be reviewed at least at each financial year-end. If expectations differ from previous estimates, the changes should be accounted for as a change in an accounting estimate in accordance with LKAS 8.

The useful life of an asset is defined in terms of its use to the business *not* in terms of economic life. The future economic benefits embodied in an asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence *and* wear and tear while an asset remains idle, would also result in the diminution of the economic benefits that might have been obtained from the use of an asset. Therefore, several factors have to be considered in determining the useful life of an asset.

LKAS 16 requires the depreciable amount of an asset to be allocated on a systematic basis over its useful life. A variety of methods such as straight-line method, diminishing balance method and unit of production method can be used for this purpose. The standard does not prescribe a particular. It states that 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 of an asset should begin when it is available for use. The depreciation charge for each period shall be recognized in profit or loss unless it is included in the carrying amount of another asset. Depreciation of an asset is recognized even if the fair value of the asset exceeds its carrying amount, as long as its residual value does not exceed its carrying amount.

Disposal of PPE

An item of PPE should be derecognized in the following situations.

- When that asset is disposed
- No future economic benefits are expected to flow to the entity.

The gains and losses arising from the disposal are recognized in profit or loss.

Disclosures

A few disclosures relevant to PPE are given below.

- Depreciation methods
- Useful lives or depreciation rates used
- Gross carrying amount and accumulated depreciation at the beginning and end of the period
- Additions
- Depreciation
- Existence and amounts of restrictions on ownership title
- Assets pledged as security for liabilities

If PPE are stated at revalued amounts, the following information should also be disclosed:

- The effective date of the valuation
- Whether an independent valuer was involved.

- Methods and significant assumptions used in assessing fair values