

Asset Management

A practical guide to accounting for property under the cost model

September 2010



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Introduction

IAS 16, 'Property, plant and equipment' includes guidance on how to account for property carried at cost. IAS 16 applies to property (that is, buildings) held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, if the property is expected to be used during more than one period. In addition, an entity using the cost model option for measuring its investment properties in accordance with IAS 40, 'Investment property', applies the principles stated in IAS 16.

This publication addresses the application of the principles in IAS 16 when applying the 'component approach' (that is, accounting for significant 'parts of an item of property, plant and equipment') for entities measuring their property, plant and equipment or investment properties at cost.

The publication does not cover all possible questions arising from the application of IAS 16, nor does it take account of any specific legal framework. Further specific information may be required in order to ensure fair presentation under IFRS. We recommend that readers refer to our publication *IFRS Manual of accounting 2010*.

What is the 'component approach'?

Property, plant and equipment (PPE) is often composed of various parts with varying useful lives or consumption patterns. These parts are (individually) replaced during the useful life of an asset. Therefore:

- Each part of an item of PPE with a cost that is significant in relation to the total cost of the item is depreciated separately (except where one significant part has a useful life and a depreciation method that is the same as those of another part of that same item of PPE; in which case, the two parts may be grouped together for depreciation purposes [IAS 16.45]; and
- The cost of a replacement of a part is recognised under the recognition principle [IAS 16.7] and the entity derecognises the carrying amount of the replaced part.

Under the 'component approach', the entity does not recognise in the carrying amount of an item of PPE the costs of the day-to-day servicing of the item. These costs are recognised in the income statement as incurred.

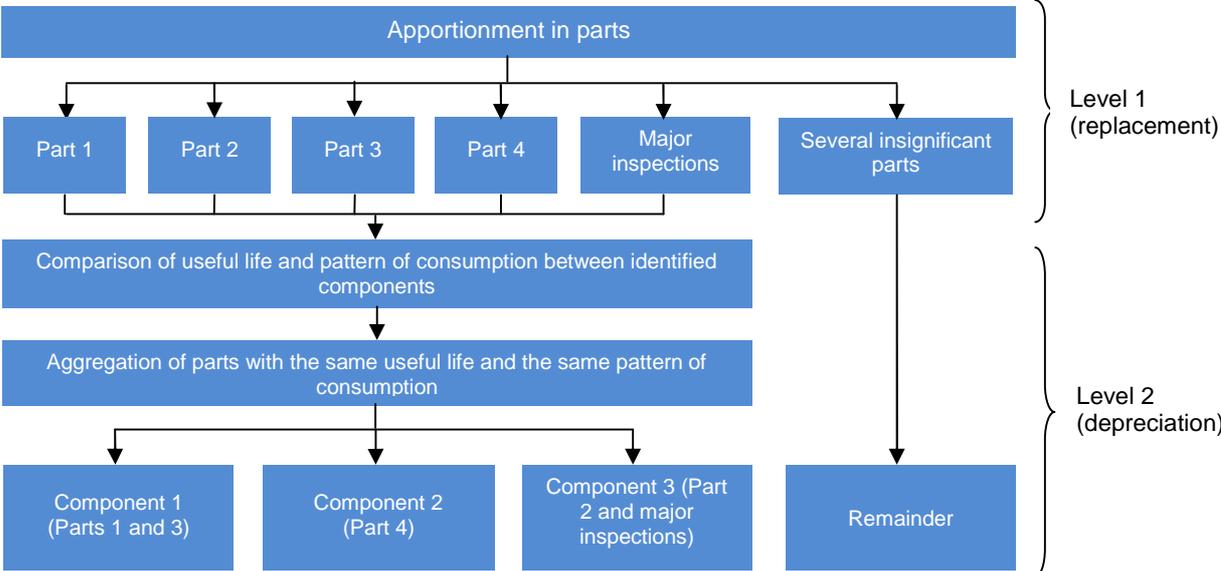
One of the objectives of the 'component approach' is therefore to reflect more precisely the pattern in which the asset's future economic benefits are expected to be consumed by the entity. The IASB did not believe that an entity's use of approximation techniques, such as a weighted average useful life for the item as a whole, resulted in depreciation that faithfully represents an entity's varying expectations for the significant parts of the asset [IAS 16, BC 26].

The above method achieves a more appropriate calculation of the depreciation, as well as the derecognition of the costs of a replacement of a part to allow the recognition of the new part.

The standard requires separate depreciation only for significant parts of an item of PPE with different useful lives or consumption patterns; however, the principles regarding replacement of parts (that is, subsequent cost of replaced part) apply generally to all identified parts, regardless whether they are significant or not.

Every item of PPE is split into parts to the extent possible in a first step to ensure that the recognition and derecognition requirements can be applied. The identified parts can then be grouped together if they have the same useful life; they can therefore form a (combined) component for depreciation purposes. Insignificant parts can be depreciated together in the remainder of the asset.

The diagram below illustrates the steps required by the 'component approach'.



1. Identification of parts of a building (level 1)

To apply the 'component approach', it is necessary to identify the various parts of an asset. There are two reasons for identifying the parts: depreciation and the replacement of parts.

Only significant parts have to be depreciated separately. Upon replacement of a part, the remaining book value of the replaced part is derecognised and the cost of the new part recognised, irrespective of whether the part was depreciated separately or not.

The identification of significant parts is a crucial step in applying the 'component approach'.

1.1 What is an item of PPE?

IAS 16 does not prescribe the unit of measure for recognition – that is, what constitutes an item of PPE. Judgement is therefore required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items and to apply the criteria to the aggregate value [IAS 16.9].

1.2 Is the significance of the cost of a part important when determining the parts of a building for replacement purposes?

No. The significance of the cost of the part compared to the cost of the total item is not a criterion for determining the parts of a building for recognition and derecognition purposes (replaced parts). However, the significance is relevant for the identification of the parts that need to be depreciated separately [IAS 16.43].

1.3 When is a part of a building significant for depreciation purposes?

The significance of a part of a building for depreciation purposes is determined based on the cost of the part in relation to the total cost of the building at initial recognition [IAS 16.43]. IAS 16 does not give more guidance about the conditions under which a part is significant.

An entity normally includes, in its accounting manual, guidance on when a part is significant. Such guidance should reflect the entity's specific circumstances, such as the type of property and the frequency of replacements.

1.4 Is it sufficient to separate a building only into two parts – interior and exterior?

It depends on the type of building, but as a general rule applicable for all types of buildings and across all regions, a separation between interior and exterior might not be sufficient.

Management should carefully evaluate whether the separation into interior and exterior truly reflects the parts of the building, taking into account the need to make replacements during the useful life of parts of the building. For example, solid walls, floors and ceiling may be used over a longer term and be replaced later than the plasterboard walls and the heating system.

1.5 Is there a minimum requirement for how many parts of a building need to be identified?

No. There is no minimum requirement for how many parts of a building should be identified. The number of parts may vary depending on the nature and the complexity of the building.

1.6 How can the parts be determined?

The standard is silent on how to determine the parts of a building. The assets' specific circumstances need to be taken into account.

In practice, the first step in determining the parts of a building should be the analysis of the construction contracts, the inspection report or the invoice (parts of the acquisition cost).

If these documents do not provide sufficient information, other sources such as construction catalogues should be taken into account. For construction catalogues to be a sufficient source, they need to be a standard that is commonly used in the economic environment in which the entity operates. In practice, it would be expected that such standards take into account the specifics of the geographical area as well as type of building.

It might be considered necessary to request an expert opinion (for example, construction experts) in order to determine the parts of a building.

The following practices are commonly used to identify the parts of a building:

Alternative I	Alternative II
<ul style="list-style-type: none">• Exterior walls• Interior walls• Windows• Ceiling• Roof• Staircase• Elevators• Air condition• Heating system• Water system• Electrical system• Major inspections	<ul style="list-style-type: none">• Structural design• Membrane• Exterior doors and windows• Interior walls, doors, windows• Heating and other technical systems• Sanitary facilities• Major inspections

1.7 Is the intention of the owner of the building taken into account when determining the parts of the building (for example, to sell the building after five years without replacing any parts)?

Yes. This is appropriate as long as the useful lives and depreciation methods for all significant parts are the same.

However, in the above scenario, the residual value of the building should take into consideration the quality and state of the various parts of the building, as they will affect the residual value of the building that also affects depreciation.

1.8 Is the age of an acquired building taken into account when identifying the significant parts of a building?

Yes. It may be the case that the building acquired is in a non-usable condition and that the entity has mainly acquired the exterior walls of the building (assuming Alternative I in Q&A 1.6 is taken). In this case, it may be the only significant part of the building at initial recognition.

1.9 Can the number of identified parts vary over time?

No. All relevant parts of a building are identified at the date of initial recognition. The number of identified parts should not vary after the date that the building is ready for use.

1.10 Is land a part of the building?

No. The land and the building are two separately identifiable assets, which are accounted for separately regardless of whether they are acquired together. Land has an unlimited useful life, with some exceptions [IAS 16.58].

2. Initial valuation of a part of a building (level 1)

IAS 16 considers the question of how individual items may be identified and the extent to which items may be aggregated. It does not prescribe the unit of measurement but states that judgement is needed in applying the recognition criteria to an entity's particular circumstances [IAS 16.9]. When talking about buildings, the unit of measurement at initial recognition is the building as a whole [IAS 16.7].

In a second step, IAS 16.44 requires the amount initially recognised for the building to be allocated to its significant parts, which should then be depreciated separately.

However, on replacement of a part, IAS 16 requires an entity to derecognise an existing part even if this part was not depreciated separately. If a part is replaced, the remaining book value of the replaced part is derecognised, and the cost of the new part is recognised. In this case, the carrying amount of the replaced part may be estimated by using the cost of the replacement as an indication.

2.1 An entity allocates the amount initially recognised in respect of a building to its significant parts [IAS 16.44]. How is the cost of the part evaluated at initial recognition of a building after completion?

IAS 16 does not state which method should be used to allocate the cost.

A direct allocation of costs to the respective part is generally necessary. This is only possible in case of own construction combined with adequate internal cost accounting, or if the supplier provides the necessary information on an individual single basis.

If no such information is available, management should use other information to determine the amount that should be allocated to the respective part. Such information (for example, construction catalogues)¹ should only be used if they are commonly available in the market and reflect the current market practice for the respective type of property.

In addition to the above, in some cases it might be useful to request an expert opinion (for example, construction experts) in order to determine the cost of the parts.

2.2 How is the cost of various parts of a building determined at the date of recognition when a building is acquired by way of an asset deal?

There is usually one purchase price for the building as a whole. This price and the directly attributable cost should be allocated to the different parts of the building. This allocation is based on the proportion of the relative construction cost of the respective part to the cost of the building as a whole.

If the acquired building is new, management may use either information provided by the contractor or other commonly available information (for example, construction catalogues or experience of the entity with the construction of similar properties).

In the case of an existing (old) building, the percentages used to allocate the cost to the parts should reflect the use of the different parts, as the proportion of the cost of a part to the cost of the building as a whole may change during the useful life of the building. Furthermore, the cost of the parts depends on the history of replacement or any maintenance backlog. The estimation should be based on available information. Market practice and construction catalogues may provide such information for different types of properties. However, the entity needs to take into account the (entity-specific) replacement plan of the individual parts. If such information is not available, the acquirer may use the experience and the replacement practice of an entity with similar properties.

¹ The following examples of commonly available and admissible information can be given: in Germany, DIN 278, NHK and other publications; in France, FSIF and CSTB; in the US, Marshall & Swift.

2.3 How is the cost of the various parts of a building determined at the date of recognition when the building is acquired within a business combination?

After having performed purchase price allocation (IFRS 3.14), the fair value of the building is allocated to the different significant parts of the building in one of the ways described above (see Q&A 2.2).

2.4 Does an entity allocate any acquisition cost to the parts of a building if it acquires a property that is a building without a market value (for example, a ruin)?

No. A building that has no market value is not a recognisable asset. No cost is therefore allocated to the parts of the building. The entity pays the acquisition price for the land and not for the building. Land and building are accounted for separately, even when they are acquired together [IAS 16.58]. However, if the cost of land includes the cost of site dismantlement, removal and restoration, that portion of the land asset is depreciated over the period of the benefits obtained by incurring those costs [IAS 16.59].

2.5 Does an entity allocate any acquisition cost to a building with a market value if it acquires a property that the entity intends to dismantle and remove after acquisition?

Yes. Even though the entity might not want to make use of the acquired building, the building is initially recognised at its cost, which should reflect the market price paid.

The entity might not need to allocate cost to the parts of the building if the building is going to be dismantled and removed as a whole without any use, or if used for a short period of time (see Q&A 1.7). Such a treatment may not be appropriate if significant parts of the acquired building will be used for the new building.

Where costs need to be allocated to the different parts of the building, they are allocated as explained in Q&A 2.2.

2.6 Can a first-time adopter of IFRS apply the 'fair value as deemed cost' exemption in order to adopt the 'component approach' and to determine net book value on the date of transition to IFRS?

Yes. The 'component approach' may be applied prospectively from the date of transition to IFRS. The entity can apply the 'fair value as deemed cost' exemption to restate the building to fair value at the date of transition. The fair value is then allocated to the different significant parts of the building. This allocation should be based on the proportion of the relative construction cost of the respective part to the cost of the building as a whole, taking into account the use of the different parts since construction.

2.7 Is management required to document the historic cost of those parts of a building that are not depreciated separately?

No. This is not required, but we recommend it. IAS 16.70 requires an entity to derecognise the carrying amount of a replaced part regardless of whether the replaced part had been depreciated separately or not. In order to ensure the correct derecognition of replaced parts, the entity might need to determine the carrying amount of the replaced parts. To do so, the entity depreciates the historic cost of each part over its useful life.

Where it is not possible to determine the carrying amount of the replaced part based on historical cost, the cost of a replacement might be a good indication of what the cost of the replaced part was at the time it was acquired or constructed [IAS 16.70].

3. Depreciation of a part of a building (level 2)

IAS 16 requires each part of a building with a cost that is significant in relation to the total cost of building as a whole to be depreciated separately. However, a significant part of a building may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that building. Such parts may be depreciated together. Additionally, such parts that are individually not significant are combined in the remainder and are depreciated together.

The cost of a part is allocated on a systematic basis over its useful life. The useful life of an asset is defined in terms of the asset's expected utility to the entity. The asset management policy of the entity may involve the disposal of the assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. The useful life of the asset may therefore be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets.

Depreciation begins when the asset is available for use – that is, when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

3.1 Is management required to estimate the useful life of the building as a whole (in addition to the useful life of the parts) at each reporting date?

Yes. IAS 16.51 requires an entity to estimate the useful life (and the residual value) of an asset at least at each financial year-end. However, an entity may choose to evaluate the estimated useful life of an asset additionally at each interim reporting date.

Based on the above, the entity is required to estimate the useful life of a building as a whole, in addition to estimating the useful lives of the parts of the building. The entity should include, in its accounting manual, guidance on how the useful life of a building as a whole is estimated and when such an estimate should be performed.

3.2 Is the useful life of a building estimated based on the average of the useful lives of the parts of the same building?

No. It is required to estimate the useful life of a building as a whole on a stand-alone basis taking into account only the expected utility to the entity. The estimation of the useful life of a building is a matter of judgement based on the experience of the entity with similar buildings and the intention of the entity to use the building [IAS 16.57]. The average of the useful lives of the parts is not a sufficient basis to estimate the useful life of the building as a whole.

3.3 Can the useful life of a building as a whole be estimated based on the economic life of one (that is, the most significant) part of the building?

No. The useful life of a building is determined based on the building's expected utility to the entity, which can be shorter than the building's economic life. However, to estimate the useful life of the building as a whole, it might be necessary to conclude from the useful life or the economic life of a significant part. Management should evaluate carefully if the useful/economic life of a building, for example, can be longer than the useful life of the structure of the building (walls, roof, etc).

3.4 Can the useful life of a part of a building be longer than the useful life of the building as a whole (for example, useful life of the building 25 years, useful life of the roof 30 years)?

In principle, no. However, an entity should carefully assess whether parts might be transferred to another building and further used. In that case, the useful life of the parts might be longer, as the useful life of the building as a whole.

Note: 'Useful life' is not the same as the 'economic life'.

3.5 Is it possible to group significant parts of a building in determining the depreciation charge?

Yes. Significant parts may be grouped and depreciated together if their useful life and the depreciation method are the same [IAS 16.45].

Insignificant parts may be grouped without the need for the same useful life and a uniform depreciation method. The remainder consists of such parts of individually insignificant cost.

3.6 Is an entity required to depreciate insignificant parts separately?

No. An entity is obliged to depreciate significant parts of a building and the 'rest of the building' separately. The 'rest of the building' consists of parts that are not individually significant. An entity groups these parts to one depreciation unit: 'the remainder'.

However, IAS 16.70 requires – even for insignificant parts – the carrying amount of a replaced part to be derecognised regardless of whether the replaced part had been depreciated separately.

Note: The cost of a replacement for a part includes the carrying amount of the replaced part regardless of whether the replaced part had been depreciated separately. It might therefore be useful to keep the records of the initial apportionment.

3.7 Can the remainder (comprising only insignificant parts) be depreciated using the useful life of the building as a whole?

No. The remainder consists of those parts of the building that are not individually significant but may have a useful life significantly different from the useful life of the building as a whole.

The applicable useful life of the remainder as well as the depreciation method used needs to be determined in a way that faithfully represents the consumption pattern and/or useful life of its parts [IAS 16.46]. The useful life of the remainder should therefore be the average of the useful life of its parts rather than the useful life of the building as a whole.

3.8 Is one remainder sufficient if the useful lives of the insignificant parts differ significantly?

The standard is silent on this issue. If the useful lives of the parts included in the remainder differ significantly (for example, parts with five years and parts with 20 years of useful life), it seems appropriate (more practical) to constitute more than one remainder. In this case, one remainder for which the depreciation rate is calculated based on the average useful life of the parts in the remainder may not faithfully represent the consumption pattern and/or the useful life of the parts [IAS 16.46].

4. Replacement of a part of a building (level 2)

Parts of some assets may require replacement at regular intervals. An entity recognises in the carrying amount of an asset the cost of the replaced parts when that cost is incurred and if the recognition criteria are met. The recognition of a part does not depend on the question whether the asset (as a whole) is improved (for example, by extending the useful life).

The carrying amounts of the replaced parts are derecognised, regardless of whether the replaced part had been part of a group or had been depreciated separately. Therefore, for the purpose of derecognition, parts are defined as those asset elements that have to be derecognised separately if replaced.

4.1 Is it necessary to recognise every replacement of a part?

Yes. It is compulsory to recognise every replacement of a part and derecognise the replaced part if the recognition criteria are met.

Note: IFRSs should be applied to material items only.

4.2 Is the (unexpected) replacement of a significant portion of the windows included in the 'part window' to be treated as a repair expense?

No. The carrying amount of the replaced windows is derecognised; the cost of the new windows is capitalised. The remaining part that is replaced later is recognised as a separate part and may be depreciated with other insignificant parts within the remainder.

However, there is no bright line of when replacement is significant. Management should therefore apply professional judgement.

5. Disclosure

5.1 Should management disclose that it applies the cost model when accounting for buildings?

Yes. Management should disclose the measurement basis used for determining the gross carrying amount for each class of PPE [IAS 16.73(a)] as well as for investment properties [IAS 40.75(a)]. However, there is no need to disclose a detailed description of how the 'component approach' is applied and how the parts have been determined.

5.2 Should management disclose the useful lives or the depreciation rates used for each part separately?

No. The disclosure requirements of IAS 16.73(b) and (c) are only required for each class of PPE (for example, land and buildings). In practice, the disclosure is given as a range by presenting the highest and lowest amount. It is not sufficient to present the average of the useful lives or depreciation rates used in that class of PPE.

5.3 Can management disclose some parts of an item separately from the other parts (for example, as equipment rather than as part of the property) on the balance sheet or in the notes?

No. The management should disclose the item of PPE as a whole. The 'component approach' only requires separation of a building into parts for depreciation and derecognition purposes.

Contacts

Kees Hage

Global RE Leader
kees.hage@lu.pwc.com
+352 49 48 48 2059

Tasos Nolas

Cyprus & Global ACS Representative
tasos.nolas@cy.pwc.com
+357 25 555 192

Ann Smolders

Belgium
ann.smolders@be.pwc.com
+32 2 7104173

Markus Schmid

Switzerland
markus.schmid@ch.pwc.com
+41 58 792 6358

Anita Dietrich

Germany
anita.dietrich@de.pwc.com
+49 69 9585 2254

Henrik Steffensen

Denmark
henrik.steffensen@dk.pwc.com
+45 39 45 3945

Gonzalo Sanjurjo Pose

Spain
gonzalo.sanjurjo.pose@es.pwc.com
+34 91 568 4989

Daniel Fesson

France
daniel.fesson@fr.pwc.com
+33 1 56 57 1062

Elisabetta Caldirola

Italy
elisabetta.c.caldirola@it.pwc.com
+390 2 778 5380

Anne-Sophie Preud'homme

Luxembourg
anne.sophie.preudhomme@lu.pwc.com
+352 49 48 48 2126

Ola Anfinsen

Norway
ola.anfinsen@no.pwc.com
+47 9526 0503

Kees Roozen

Netherlands
kees.roozen@nl.pwc.com
+31 20 568 5281

Malgorzata Szymanek-Wilk

Poland
malgorzata.szymanek-wilk@pl.pwc.com
+48 22 523 4131

Johan Ericsson

Sweden
johan.ericsson@se.pwc.com
+46 8 555 330 37

Karl Hairon

Jersey
karl.hairon@je.pwc.com
+44 1534 838522

Sandra Dowling

UK
sandra.dowling@uk.pwc.com
+44 20 7804 3972

James Dunning

Sydney
james.dunning@au.pwc.com
+61 2 826 62933

Alan Ho

Hong Kong
alan.ho@hk.pwc.com
+852 2289 2168

Takeshi Shimizu

Japan
takeshi.shimizu@jp.pwc.com
+81 90651 51754

Eng Beng Choo

Singapore
eng.beng.choo@sg.pwc.com
+65 6236 3848

Andrew Popert

Canada
andrew.popert@ca.pwc.com
+1 416 228 4202

Tom Wilkin

US
tom.wilkin@us.pwc.com
+1 973 236 4251

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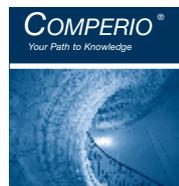
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