BACKGROUND:

VicRoads (The Roads Corporation) is an Australian State government agency which controls the Victorian road network infrastructure assets valued at approximately $A15 billion. Accordingly, VicRoads maintains a keen interest in accounting standards relevant to complex assets and welcomes the opportunity to submit comments regarding the proposed changes to IAS 16 "Property, Plant and Equipment". Please find below our comments and suggestions.

OVERVIEW:

VicRoads is concerned that some of the proposed changes to IAS 16 may generate divergent accounting practices in the treatment of "components" of complex assets. Specifically, there is concern that the collective requirements of paragraphs 7, 12, and 22A-C, are open to interpretation. As a result, a particular complex asset may be addressed in four different ways depending upon an entity's interpretation of the requirements:

- recognition of a component part only if the individual component satisfies the paragraph 7 recognition criteria in its own right (based on the requirements of paragraph 7);
- recognition of a component part regardless of whether the individual component satisfies the paragraph 7 recognition criteria in its own right (based on the requirements of paragraphs 12 and 22A);
- recognition of the composite asset, but calculation of depreciation based upon component part characteristics (based on the recognition criteria within paragraph 7, but the requirements of paragraph 12 and 22A);
- recognition of the composite asset and calculation of depreciation based upon the composite asset characteristics (based on the recognition criteria within paragraph 7, and the reference to paragraph 7 within paragraph 22B).

DISCUSSION:

Recognition of Components - Requirements

Comments / rationale

Paragraph 7 establishes the recognition criteria for property, plant and equipment, indicating that "*an item of property, plant and equipment shall be recognised as an asset when, and only when:*

(a) it is probable that future economic benefits associated with the asset will flow to the entity; and

(b) *the cost of the asset or, when the asset is carried at a revalued amount, the fair value of the asset, can be measured reliably*."

However, paragraph 12, which requires an entity to "account for each component separately", currently makes no reference to the need for a component part to satisfy the paragraph 7 criteria to qualify for recognition. Similarly, paragraph 22A, which advocates capitalisation of expenditure incurred in replacing/renewing components, currently makes no reference to the need for the component to satisfy the recognition criteria. Paragraphs 22B-22C make reference to paragraph 7, suggesting that your intention is for individual component parts to be separately recognised only when the component part satisfies the recognition criteria in its own right. We believe adding a reference to the overriding paragraph 7 recognition criteria within paragraphs 12 and 22A would reduce the likelihood of any misinterpretation.

In addition, paragraph 12 and 22A refer to the need to "account for" components. It is unclear whether:

(a) "account for" is intended to be synonymous with "recognise", requiring recognition of the component parts; or
(b) "account for" requires recognition of the composite asset, but the calculation of depreciation by reference to the characteristics of the component parts.

We have assumed "account for" is synonymous with "recognition", requiring recognition of the components.

In our opinion, it would be inappropriate to recognise a component part as a separate asset unless the component part could satisfy the paragraph 7 recognition criteria in its own right. Any other approach would contravene paragraph 7 and undermine the authority of the recognition requirements. If this distinction is not highlighted within the standard, there is a risk that divergent accounting practices will result. Specifically, a particular complex asset may be addressed in four different ways depending upon an entity's interpretation of the requirements:

- recognition of a component part only if the individual component satisfies the paragraph 7 recognition criteria in its own right (based on the requirements of paragraph 7);
- recognition of a component part regardless of whether the individual component satisfies the paragraph 7 recognition criteria in its own right (based on the requirements of paragraphs 12 and 22A);
- recognition of the composite asset, but calculation of depreciation based upon component part characteristics (based on the recognition criteria within paragraph 7, but the requirements of paragraph 12 and 22A);
- recognition of the composite asset and calculation of depreciation based upon the composite asset characteristics (based on the recognition criteria within paragraph 7, and the reference to paragraph 7 within paragraph 22B).

<u>Suggestion:</u>
Accordingly, we suggest that paragraph 12 and 22A be amended as follows:

"12. An entity allocates the amount initially recognised in respect of an asset to its component parts and ~~*accounts for*~~ <u>**recognises**</u> *each component separately*<u>**, to the extent that the individual components satisfy the paragraph 7 recognition criteria and**</u> *have different useful lives or provide benefits to the entity in a different pattern."*

"22A. *Expenditure incurred in replacing or renewing a component of an item of property, plant and equipment shall be* ~~*accounted for*~~ <u>**recognised**</u> *as the acquisition of a separate asset* <u>**provided the component satisfies the recognition criteria in paragraph 7. In such cases**</u>*, the carrying amount of the replaced or renewed component asset shall be written off."*

<u>Recognition of Components – Illustrative examples</u>

<u>Commentary / rationale</u>
Collectively, paragraphs 12, 22B and 22C give the following examples of potential component assets:

Aircraft

- Airframe
- Engines
- Seats and galleys
- Major inspections

Furnace

- Lining

However, the standard does not currently demonstrate how these "components" satisfy the paragraph 7 recognition criteria. In the absence of further explanatory discussion, readers may not understand how these components qualify for separate recognition. For example, readers may not appreciate how inspection costs could qualify for capitalisation as a separate component, instead viewing inspection costs as costs to be either expensed as maintenance, or capitalised as subsequent expenditure in relation to the asset inspected (under paragraph 23 as appropriate). This confusion may hinder appropriate interpretation and application of the standard.

<u>Suggestion:</u>
We recommend that the illustrative examples currently provided within paragraphs 12, 22B-22C be reviewed. The inclusion of a few detailed examples, perhaps by way of Appendix, would facilitate implementation and application of the standard. We recommend the inclusion of an example which highlights the recognition of components only to the extent that the components satisfy the paragraph 7 recognition criteria. For example:

An entity utilizes a mechanical production line for the processing of fabric. Overall, the production line has a useful life of 10 years, due to expected technological obsolescence. Essentially, the production line comprises three inter-related machines - the cutting machine, the stitching machine and the pressing machine. Each machine comprises various parts – metal casing, engines, blades, electrical connections etc. Each machine can be removed from the production line and redeployed elsewhere. It is expected that the cutting machine and the stitching machine will require replacement after 5 years; the pressing machine will be replaced after 10 years. The cutting machine blades will be replaced annually; the stitching machine needles will be replaced monthly. Each machine will also require servicing annually (oiling, testing etc).

In determining whether any "components" of the production line should be recognised, consideration must be given to the extent to which the components satisfy the paragraph 7 recognition criteria. In this case, each machine is genuinely useful in its own right – each machine can provide benefits outside the context of the fabric processing production line. For example, each machine could be added to another production line or operate as a "stand-alone" unit. Each machine embodies future economic benefits and qualifies for recognition under paragraph 7. Accordingly, each machine should be recognised, measured and depreciated separately. The replacement of these machines would necessitate the capitalisation of the new machines and the writing-off of the old machines in accordance with paragraph 22A.

In contrast, the blades, engines, casing, etc within each machine provide no real benefit in isolation (other than as spare parts). They are merely "ingredients" that are combined to create a useful integrated structure. Accordingly, these parts, in isolation, do not embody future economic benefits and do not qualify for recognition under paragraph 7. The replacement of these parts would represent maintenance of the associated machine. Such costs could only be capitalised if they increased the future economic benefits embodied within the machine in excess of the standard of performance assessed immediately before the expenditure (in accordance with paragraph 23). Otherwise, this expenditure would be expensed as maintenance (in accordance with paragraph 23A).

CONCLUSION:

Thank you for the opportunity to submit comments and suggestions regarding the proposed changes to IAS 16. In summary, VicRoads encourages amendments to paragraphs 12 and 22A-C to reduce the likelihood of any misinterpretation and facilitate implementation of the standard.

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VICROADS