New South Wales
TREASURY

ACCOUNTING POLICY

GUIDELINES FOR CAPITALISATION OF EXPENDITURE ON PROPERTY, PLANT AND EQUIPMENT

Office of Financial Management

Policy & Guidelines Paper

TPP 06-6 **June 2006**

PREFACE

The *Guidelines for Capitalisation of Expenditure* discuss the Accounting Standard distinction between capitalising and expensing property, plant and equipment costs. The Guidelines are applicable to all NSW public sector agencies (including Statutory State Owned Corporations) for financial years beginning on or after 1 January 2005.

The main purposes of the Guidelines are to:

- provide relevant and useful information on, and improved accountability for, resource allocation and asset management; and
- achieve a consistent treatment of property, plant and equipment costs across the New South Wales public sector.

The Guidelines provide guidance and a policy framework within which each agency can develop its own operational rules and update its asset maintenance plans and strategies in line with the Government's Total Asset Management policy. The Guidelines have been updated as part of the adoption of Australian equivalents to International Financial Reporting Standards. They replace all previous Guidelines on this topic.

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June 2006

Treasury Ref: **TPP 06-6**
ISBN: **0 7313 3316 0**

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EXECUTIVE SUMMARY

This Policy Paper provides direction to NSW Public Sector agencies on the Accounting Standard distinction between capitalising and expensing property, plant and equipment costs. These Guidelines provide additional practical guidance to Australian Accounting Standards and Urgent Issues Group (UIG) Interpretations. They replace all previous Guidelines on this topic.

The specific purposes of the Guidelines are to:

- provide relevant and useful information on, and improved accountability for, resource allocation and asset management; and
- achieve a consistent treatment of property, plant and equipment costs across the New South Wales public sector.

The Guidelines require agencies to capitalise expenditure on an asset if, and only if:

- it is probable that future economic benefits associated with the item will flow to the entity; and
- the cost of the item can be measured reliably.

This document complies with the requirements of AASB 116 *Property, Plant and Equipment*, AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* and UIG Interpretation 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*.

The Guidelines have been updated as part of the adoption of Australian equivalents to International Financial Reporting Standards (AEIFRS). Except for some limited areas, for most entities there will be no material differences resulting from these Guidelines compared to the previous Policy TPP 00-3 (refer Appendix A).

1. INTRODUCTION

1.1 Purpose of the Guidelines

This Policy Paper provides practical guidance on the treatment of expenditure on physical non-current assets in the NSW Public Sector. The Guidelines are designed to:

- *provide relevant and useful information on, and improved accountability for, resource allocation and asset management*

  In applying the Guidelines, an agency needs to specify an asset's future economic benefits in terms of its various components (i.e. capacity, quality and useful life) as well as the required level and timing of maintenance to achieve the pre-determined economic benefits and useful life.

- *achieve a consistent treatment of property, plant and equipment costs across the NSW public sector*

  The Guidelines assist agencies distinguish what is capitalised from what is expensed and require agencies to:

  - clearly specify the 'future economic benefits' of assets in terms of their service capacity, service quality and expected useful life (see sections 2.4 and 4.1.1 – 4.1.3);
  - separately recognise material parts of assets and depreciate those assets over their shorter useful life (see section 2.3.2);
  - capitalise expenditure on assets when, and only when (see section 2.2):
    - the expenditure gives rise to future economic benefits; and
    - the cost of the item can be measured reliably; and
  - clearly document and disclose their capitalisation policy. Only material amounts should be capitalised. The capitalisation thresholds in section 3.1 provide guidance.

The Paper does not address the treatment of expenditure on other potential assets such as intangibles, biological assets, easements, etc. For further information on these issues, agencies should refer to the NSW Treasury Analysis on AASB 138 Intangible Assets at http://www.treasury.nsw.gov.au/ias/ias_analysis.htm

1.2 Application and Operative Dates

These Guidelines are issued as a Treasurer's Direction under sections 9 and 45E of the *Public Finance and Audit Act 1983* and are applicable for financial years beginning on or after 1 January 2005. A specific reference in the Statements of Corporate Intent of Statutory State Owned Corporations will mandate these Guidelines.

The adoption of these Guidelines coincides with the adoption of the AEIFRS. The Guidelines must be applied retrospectively by adjusting the opening balance of each affected component of equity at the beginning of the comparative period (i.e. 1 July 2004 for 30 June year-end entities). This is consistent with AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards* and AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*.

These Guidelines replace the 2000 *Guidelines for the Capitalisation of Expenditure in the NSW Public Sector* (TPP 00-3) and Treasury Circular TC 00/13 *Guidelines for the Capitalisation of Expenditure in the NSW Public Sector* is withdrawn.

2. ASSET DEFINITION AND RECOGNITION CRITERIA

2.1 Asset definition

The *Framework for the Preparation and Presentation of Financial Statements* (the Framework) defines an 'asset' as 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity'. For not-for-profit entities, 'future economic benefits' are synonymous with the notion of service potential, which the Framework describes as the '...scarce capacity to provide benefits to the entities that use them' (Framework, para 49(a) and para Aus49.1).

2.2 Asset recognition

According to AASB 116 *Property, Plant and Equipment*, agencies should capitalise the cost of an item of property, plant and equipment when and only when (AASB 116, para 7):

- it is probable that the future economic benefits associated with the item will flow to the entity; and
- the cost of the item can be measured reliably.

The asset recognition principles in AASB 116 are the same for initial costs and subsequent costs (AASB 116, para 10). This was not the case under the previous standard. Under AASB 116, if an item of expenditure meets the above asset definition and recognition criteria, it is to be treated as an asset for accounting purposes, subject to the agency's capitalisation threshold tests (refer section 3.1).

2.3 Unit of measure

2.3.1 What constitutes an asset?

AASB 116 does not prescribe the unit of measure for asset recognition; that is, what constitutes an item of property, plant and equipment (AASB 116, para 9). Agencies must use professional judgement to apply the recognition criteria to the specific circumstances, taking into consideration the following issues:

- how their business is managed:
  - how does management assess and monitor performance?
  - is the business managed on an individual, functional, geographical or total entity basis?
  - is the business managed on the basis of a cash generating unit?
  - what is the regulatory approach adopted in respect of the entity's economic and operational activities?

- what constitutes an operating asset:
  - does an item have utility by itself or only when operating in conjunction with other items of property, plant and equipment?
  - what items of property, plant and equipment would be aggregated to constitute an asset for the purposes of disposal?

The unit of measure is particularly relevant to for-profit entities, because offsetting revaluation increments and decrements must be done on an individual asset basis (AASB 116, paras 39-40). This is a change from the previous standard which permitted the 'class of asset' approach. Not-for-profit entities must continue to use the class of asset approach and may offset within a class of assets (AASB 116, para Aus40.2).

This is more fully discussed in NSW Treasury Policy Paper 05-3 *Valuation of Physical Non-Current Assets at Fair Value*.

2.3.2 Parts of Assets

Under AASB 116, parts of assets (previously referred to as components) are not separate assets (AASB 116, para 43). Previously, 'components' were treated as separate assets. However, a group of parts or components may be considered a single asset. Where major parts of an asset have useful lives materially different from the asset and therefore require replacement during the life of the asset, each part is depreciated over its shorter useful life (AASB 116, para 44). For example, an aircraft has significant parts (the airframe and the engines) that can be depreciated separately. However, the asset is the aircraft.

The separate depreciation of material parts of assets is important in distinguishing between replacement and maintenance of assets. It also reflects the useful life of the part, as well as the removal and replacement of the parts in both accounting and physical terms.

Examples of complex assets that may contain parts include electricity generating plants, water / sewerage networks, rail networks, road and water channels and most general and special purpose buildings (e.g. office blocks and hospitals).

2.4 Specification of Economic Benefits

The identification, recognition and valuation of an asset require clear specification of the economic benefits associated or embodied in an asset. Without such specification, it is not possible to determine whether a particular item of expenditure represents a replacement, an enhancement or day-to-day servicing costs (i.e. maintenance expense). The specification of the asset and its parts needs to be determined at the commencement of the asset's life to enable the proper accounting and management of that asset. Agencies should consider such aspects as service capacity, service quality and useful life when identifying assets. This is further discussed in Section 4 below.

3. INITIAL ACQUISITION

AASB 116 requires an entity to evaluate all property, plant and equipment costs under the recognition criteria discussed above. These costs include the initial costs to acquire or construct an item, as well as subsequent costs (AASB 116, para 10).

AASB 116 clarifies that items of property, plant and equipment acquired for safety or environmental reasons qualify for asset recognition. This is because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had they not been acquired. The resulting carrying amount of such assets should be reviewed for impairment in accordance with AASB 136 *Impairment of Assets* (AASB 116, para 11). Agencies should refer to Section 5 of NSW Treasury Policy Paper 05-3 *Valuation of Physical Non-Current Assets at Fair Value* for further information on impairment of assets.

3.1 Capitalisation Threshold Guidance

In determining whether entities should capitalise costs incurred, the following thresholds are provided by Treasury as guidance only:

- Physical non-current assets or parts of an asset costing more than $5,000 individually should be capitalised.
- Assets or parts of an asset with acquisition cost less than $500 should be charged as an expense in the year of acquisition.
- In respect of assets or parts of an asset that cost between $500 and $5,000, the question of capitalisation is a matter for professional judgement by individual agencies based on materiality.
- Generally, the costs of assets or parts of an asset that form part of a network (e.g. computer system and office furniture) should be aggregated together when applying the capitalisation threshold. For example, although each individual item making up a set of office furniture may not be material, the total cost of the network could well exceed $5,000 and therefore should be capitalised.

As the above is provided for guidance only, individual agencies may determine different thresholds on the basis of materiality within the overall context of the financial statements. However, agencies must clearly document and disclose their capitalisation policy in their financial reports.

4. SUBSEQUENT COSTS

AASB 116 requires agencies to evaluate subsequent costs under the recognition criteria. Subsequent costs may add to, replace part of, or service property, plant and equipment (AASB 116, para 10).

Although AASB 116 does not specifically refer to 'enhancements' when discussing subsequent costs, paragraph 10 discusses costs that 'add to' an item of property, plant and equipment. These Guidelines refer to subsequent costs that 'add to' the item as 'additions' or 'enhancements' and discuss these costs below.

4.1 Additions or enhancements

As discussed in section 2.4, agencies must be able to clearly specify future economic benefits (one of the asset recognition criteria) when identifying assets. This is also necessary to evaluate whether subsequent costs satisfy the recognition criteria. This requires agencies to consider service capacity, service quality and useful life when assessing the expenditure.

4.1.1 Service capacity

Expenditure which increases an item's service capacity is accounted for as an enhancement. Examples are the extension of a dam wall that results in an increase in water storage capacity, building an extension to provide another hospital ward and widening a road from two to four carriageways. The increase in capacity must be both an effective and material increase.

An increase in service capacity is effective if it meets increases in demand. If the increase is only incidental to the necessary maintenance of the existing service capacity or the additional capacity will not actually be used in the foreseeable future, then the expenditure would be classified as maintenance expense.

Difficulties may arise where the expenditure is less clearly an enhancement, particularly in cases where the expenditure may be part enhancement and part maintenance of the existing service capacity. If the enhancement to the asset is not material, there may be little benefit in trying to estimate the value of the enhancement component.

In addressing the question of materiality, agencies should consider the cumulative effect of the expenditure. Whilst improving a small stretch of water channel may be immaterial on its own, when it is part of a planned capital program involving numerous improvements, the total impact of that program may be material.

Agencies should develop their own policies for the various types of expenditure based on these guidelines.

4.1.2 Service quality

Improvement in the quality or standard of service provided represents an enhancement to an asset. Examples include expenditure on strengthening a dam wall, improving the lining of a water channel and reorganising the internal layout of a hospital ward in line with more modern standards.

The enhancement in quality must be effective and material. Replacing worn out wooden sleepers on a rail line with concrete sleepers as an incidental part of maintaining a small section of rail would not represent an enhancement. Although the concrete sleeper is of a higher quality, it is immaterial in absolute and relative terms and not cost effective to segregate. On the other hand, installing higher grade rail or replacing wooden sleepers with concrete sleepers as part of a general project to upgrade the operating standard represents an enhancement to an existing asset. It adds effectively and materially to the quality and therefore to the total future economic benefits of the network.

Aesthetic improvements to an asset or 'beautification' projects that do not result in some measurable efficiency or quality improvement do not increase service quality and would not be recognised as an asset.

4.1.3 Useful life

AASB 116 defines useful life as the period over which an asset is expected to be available for use by the agency, or the number of production or similar units expected to be obtained from the asset by the agency (para 6). In determining useful life, agencies should consider the following factors: expected usage, expected physical wear and tear, technical or commercial obsolescence and legal or similar limits on use (AASB 116, para 56).

The initial assessment of an asset's useful life (including a part of an asset) assumes that a certain repair and maintenance program will be necessary for the asset (or part) to achieve its anticipated useful life (AASB 116, para 56(b)). In this context, maintenance work does not normally extend an asset's useful life but merely permits the useful life to be realised.

Subsequent costs can only be accounted for as an enhancement if they effectively and materially increase the asset's useful life. It is important to distinguish this type of capital expenditure from day-to-day servicing costs, which are only aimed at ensuring the achievement of the asset's pre-determined useful life. For example, the cost of rectifying a breakdown of an item of plant and equipment is not a capital expenditure as it is made only to ensure that the plant and equipment will remain operational during its expected useful life.

During the life of an asset, an asset enhancement may occur. For example, an item of plant that is originally assessed to have a life of 10,000 hours of operating time is operated for 3,000 hours over a year. The plant then undergoes an enhancement that adds a further 2,000 hours operating time to its life. After the enhancement, the item of plant can be viewed as having a total life of 12,000 hours, which is an improvement on the originally assessed 10,000 hours and the relevant expenditure is capitalised.

4.2 Asset replacement

AASB 116 requires that the replacement of an asset (including a part of an asset) must be capitalised when the recognition criteria are satisfied (AASB 116, paras 10 and 13). Where major parts of an asset have useful lives materially different from the asset and therefore require replacement during the life of the asset, each part is depreciated over the shorter of its useful life and the asset's useful life (AASB 116, para 46).

Complex assets such as service delivery networks, buildings and major items of plant and equipment may comprise a number of major parts which have different useful lives and may be replaced during the useful life of the complex asset.

4.2.1 Replacement of physical parts of assets

AASB 116 requires each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item to be separately depreciated (AASB 116, para 43). This requires agencies to break down their existing assets into parts and assign appropriate values to the individual parts.

Further, AASB 116 requires replacement of an item or part of an item to be capitalised (AASB 116, paras 10 and 13) when the recognition criteria are satisfied.

AASB 116 para 13 provides examples of parts of assets requiring replacement: a furnace that requires relining after a certain number of hours of use, aircraft interiors that may be replaced several times during the life of the aircraft or the interior walls of a building that may have to be replaced. In these situations, the cost of replacing a part of an item is recognised in the carrying amount of the item and the carrying amount of the replaced part is derecognised.

There may also be circumstances not discussed in the Standard where the different parts of service potential in an asset are not readily identifiable. For example, a shipping channel that has a very long life may be designed with extra depth that needs to be dredged once every five years. The shipping channel is considered to have two parts. One part is the channel to its normal depth that is depreciated over its very long life. The second part is the extra channel depth where the expenditure incurred in creating the extra channel depth meets the asset recognition criteria and is depreciated over its five-year life. In this situation, the dredging of the channel every five years represents the replacement of the part.

In addition, AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* clarifies that the cost of replacing major parts cannot be recognised as a liability (refer Appendix C of AASB 137, Example 11A and Example 11B). Even where there is a legal requirement to refurbish or replace a part, this does not make the costs a liability, because no obligation exists to refurbish independently of the entity's future actions. That is, the entity can avoid the future expenditure by its future actions. Therefore, instead of a provision being recognised, the depreciation of the part takes account of the future incidence of these costs.

In many instances, replacement of a part of an asset is equivalent to what was previously referred to as major periodic maintenance. This is discussed further in Appendix A.

4.2.2 Major inspection costs

As well as the replacement of physical parts, AASB 116 also addresses major inspection costs. These costs often, but not always, relate to the labour cost of major inspections, distinct from the cost of replacing physical parts.

AASB 116 para 14 states:

> "A condition of continuing to operate an item of property, plant and equipment (e.g. an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed."

This means that, on initial acquisition or construction, major inspection costs not separately identified must be reallocated as a portion of the recognised value, rather than being added to the cost or fair value of property, plant and equipment. The treatment of major inspection costs as part of a fair value revaluation is further discussed in Treasury's Policy Paper TPP 05-3 *Valuation of Physical Non-Current Assets at Fair Value*.

The concept of major inspection costs is best illustrated by way of an example. Take an aeroplane that has a part, an engine, with a useful life of twenty years. In calculating the useful life, assume that a major overhaul will be undertaken every five years. The overhaul of the engine, however, does not 'replace' the engine as a component part of the aeroplane. That is, the overhaul may involve stripping down the engine, replacing some sub-component parts, cleaning and / or repairing other parts, leaving still others unchanged and reassembly. In such instances, it may be impractical to separately account for the engine's sub components as replacement of physical parts. Therefore, the costs associated with the physical sub-components used during the overhaul cannot be capitalised as there is no separately identifiable physical component that is replaced. These costs do not represent the replacement of a physical part, in accordance with AASB 116, para 13 and as discussed in section 4.2.1. However, in accordance with AASB 116, para 14, the labour costs associated with the major inspection cost are recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied.

The capitalisation of the major inspection costs (i.e. the labour costs), in part, reflects the fact that the overhaul has partially restored the engine's future economic benefits and its value after the overhaul is increased compared to before the overhaul was conducted.

Previously, major inspection costs that were not associated with a separately identifiable physical part would have been expensed. In the past, this was also discussed as part of the concept of major periodic maintenance, as referred to in Appendix A.

4.3 Maintenance expense

The term "maintenance expense" used in this Policy is referred to as "day-to-day servicing costs" in AASB 116.

Maintenance expense includes all costs incurred in planning, supervising, managing or executing works involved in or related to maintaining the assets owned or controlled by the agency.

These costs include labour and materials for such maintenance works, whether undertaken by the agency's employees or carried out under contract to the agency or by another agency on its behalf.

AASB 116 distinguishes between day-to-day servicing costs made to help maintain the future economic benefits that an entity can expect from an asset (AASB 116, para 12) and the replacement of parts of an asset . Therefore, subsequent expenditure that does not represent the replacement or an enhancement of an asset (or a part of an asset) in terms of its previously determined service capacity should be expensed as maintenance.

Examples of such expenditure are the ad hoc painting of a building, electrical and plumbing repairs, and the patching of the potholes in a road.

5. ELEMENTS AND MEASUREMENT OF COST

5.1 Elements of cost

According to AASB 116, the cost of an item of property, plant and equipment comprises (AASB 116, para 16):

- the purchase price less trade discounts and rebates;
- directly attributable costs to get the asset to the location and condition necessary for it to be capable of operating in the manner intended; and
- the initial estimate for dismantling and removing the item and restoring the site on which it is located, the obligation for which the entity incurs on acquisition or as a result of use of the item.

The accounting treatment for dismantling, removal and restoration costs was not previously addressed in Australian Accounting Standards and is further discussed in section 5.1.1 below.

Examples of directly attributable costs provided in AASB 116 include (AASB 116, para 17):

- costs of site preparation;
- initial delivery and handling costs;
- installation and assembly costs;
- professional fees;
- costs of employee benefits (as defined in AASB 119 *Employee Benefits*) arising directly from the construction or acquisition of the item; and
- costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment).

Further, AASB 123 *Borrowing Costs* permits an option for borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset to be capitalised or expensed as part of the cost of an asset. This is further discussed in section 5.1.2 below.

5.1.1 Dismantling, removing and restoring the item

When an entity purchases, constructs or uses an asset, it may assume or incur a contractual, statutory or constructive obligation to dismantle and remove the item or restore the site to certain minimum standards or both, at the end of the asset's life. Where these costs are recognised as a liability in accordance with AASB 137, AASB 116 para 16(c) requires that these costs be capitalised and depreciated. As these costs will not become payable until some future date and there is likely to be uncertainty about the dollar value, the entity should record its best estimate of the obligations. The amount capitalised will be the amount estimated to be paid, discounted to the date of recognition. The related credit will be recognised as a provision (AASB 116, para 16(c) and UIG 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*, para 1).

In assessing whether a restoration provision is recognised (and the corresponding restoration cost capitalised), agencies must consider whether:

- there is a legal or constructive obligation;
- it can be reliably measured; and
- it is material in net present value terms.

For example, an entity should recognise restoration costs if there is a legal **or** constructive obligation. The lack of a legal obligation is not sufficient to prevent the need to recognise the cost as there may still be a constructive obligation. The fact that the entity has sold contaminated land unremediated in the past does not negate the existence of the liability, as this would have been reflected in the sale price.

It is only those obligations arising from past events that exist independently of an entity's future actions that are recognised as provisions (AASB 137, para 19-22, Appendix C, Examples 2A, 2B and 3). This may arise as a consequence of installation or as a consequence of using an item (AASB 137, para 19, Appendix C, Example 3). An intention to operate differently in future is not a present obligation as there is no obligating event; e.g. intention to fit smoke filters in a factory (AASB 137, para 19 and Appendix C, Example 6).

Examples in the Standard for provisions for restoration / remediation costs include (AASB 137, para 19):

- penalties or clean-up costs for unlawful environmental damage; and
- decommissioning costs of an oil installation or nuclear power station to the extent the entity is obliged to rectify damage already caused.

However, the amounts may not be easily determined due to the long time frames commonly involved.

This is further discussed in the NSW Treasury Policy Paper 05-3 *Valuation of Physical Non-Current Assets at Fair Value*. Accounting for changes in restoration or remediation costs is further outlined in UIG Interpretation 1.

5.1.2 Borrowing costs

AASB 123 permits a choice between two treatments for borrowing costs. The benchmark treatment directs entities to expense all borrowing costs in the period in which they are incurred (AASB 123, para 7). The allowed alternative treatment is capitalising borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset and expensing all other borrowing costs (AASB 123, para 11). This is a change from the previous standard that required entities to capitalise costs directly attributable to a qualifying asset and expense other borrowing costs. This Treasury policy requires all NSW general government sector agencies to apply the benchmark treatment of expensing all borrowing costs to harmonise with Government Finance Statistics. Public Trading Enterprises may choose either option. The agencies' financial reports should disclose the accounting policy adopted for borrowing costs.

5.2 Measurement of cost

AASB 116 para 15 states that an item of property, plant and equipment that qualifies for recognition as an asset must be measured at its cost. However, in respect of not-for-profit entities, where an asset is acquired at no cost or for nominal cost, the cost is its fair value at the date of acquisition (AASB 116, para Aus15.1). Further, for-profit entities that receive a government grant of a non-monetary asset must recognise both the grant and asset at fair value (AASB 120, *Accounting for Government Grants and Disclosure of Government Assistance*, para 23).

Accounting for equity transfers between public sector agencies is separately discussed in NSW Treasury Policy Paper *Contributions by Owners Made to Wholly-Owned Public Sector Entities*.

The cost of one or more items of property, plant and equipment acquired in exchange for non-monetary assets or in combination with monetary assets is measured at fair value, except as discussed in section 5.2.1 below.

5.2.1 Exchanges

The cost of exchanges for a non-monetary asset or assets, or a combination thereof, is measured at fair value unless the transaction lacks commercial substance or fair value is not reliably measurable. If not able to be measured at fair value, cost equals the carrying amount of the asset given up (AASB 116, para 24).

To determine whether or not there is commercial substance, the entity should consider the extent to which future cash flows are expected to change as a result of the transaction. Commercial substance exists if (AASB 116, para 25):

- the configuration (risk, timing and amount) of cash flows of the asset received differ from the configuration of the cash flows of the asset transferred; or
- the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and
- the difference above is significant relative to the fair value of the assets exchanged.

Fair value of an asset, where comparable market transactions do not exist, is reliably measurable if (AASB 116, para 26):

- the variability in the range of reasonable fair value estimates is not significant for that asset; or
- the probabilities of various estimates within the range can be reasonably assessed and used in estimating fair value.

6. DISCLOSURE REQUIREMENTS

Information on an agency's capitalisation policy and maintenance expenditure is relevant to an understanding of the financial report.

Therefore, this Policy requires agencies to disclose in the notes to the financial report:

(a) capitalisation policy

(b) total maintenance expense, dissected into:

  (i) employee related maintenance expense included in total employee related expenses as disclosed in the operating statement or notes to the accounts as required by paragraphs 86, 91, 92 and 93 of AASB 101 *Presentation of Financial Statements;* and

  (ii) contracted labour and other (non-employee related) expenses

7. OTHER REFERENCES

Reference should be made to other Treasury publications that deal with financial reporting matters: http://www.treasury.nsw.gov.au/account/finrpt.htm

APPENDIX A

MAIN DIFFERENCES COMPARED TO PREVIOUS AUSTRALIAN AND NSW TREASURY REQUIREMENTS

1. AASB 116 *PROPERTY, PLANT AND EQUIPMENT*

AASB 116 consolidates and substantially replicates the requirements of replaced Australian Standards, except for the areas discussed below. AASB 116 replaced AASB 1041 *Revaluation of Non-Current Assets*; AAS 4 *Depreciation*; and AAS 21 *Acquisition of Assets*.

1.1 RECOGNITION

- AASB 116 doesn't differentiate between initial and subsequent costs. The recognition criteria are the same for all costs (AASB 116, para 10). AAS 4 para 5.7 used different recognition criteria for subsequent costs based on whether they added to the future economic benefits 'in excess of the originally assessed standard of performance of the existing assets.'
- Initial costs capitalised include items of property, plant and equipment acquired for safety or environmental reasons (AASB 116, para 11). Such items enable an entity to obtain future economic benefits from related assets. Australian GAAP did not previously address this issue.

1.2 MEASUREMENT

- 'Cost' under AASB 116 differs to 'cost' under AASB 1041 because of new treatments for restoration costs, major inspection costs and borrowing costs as discussed below.
- Decommissioning and restoration costs include the initial estimate for 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 (AASB 116, para 16 (c)). The obligation is recognised and measured in accordance with AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* as a provision. Australian GAAP did not previously address this issue.
- Major inspection costs (AASB 116, para 14):
  - The cost of major inspections for faults is recognised in the carrying amount of an asset as a replacement if the recognition criteria are satisfied (regardless of whether physical parts are replaced or the cost of an inspection was initially identified when the item was acquired or constructed).
  - Any remaining carrying amount of the previous inspection (as distinct from physical parts) is derecognised.
  - The estimated cost of a future inspection may be used to estimate the cost of the inspection component when the item was acquired or constructed.

  Australian GAAP did not previously address major inspection costs.

- Borrowing costs: AASB 123 (paras 7 and 10-11) permits a choice between two treatments for accounting for borrowing costs. The benchmark treatment directs entities to expense all borrowing costs in the period in which they are incurred. The allowed alternative treatment is capitalising borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset and expensing all other borrowing costs. This is a change from the previous standard that required entities to capitalise costs directly attributable to a qualifying asset and expense other borrowing costs. NSW Treasury has mandated general government sector agencies to apply the benchmark treatment of expensing all borrowing costs to harmonise with Government Finance Statistics. Public Trading Enterprises may choose either option.
- Cost of acquisition of property, plant and equipment in exchange for non-monetary assets or in combination with monetary assets: the cost is measured at fair value, unless either the transaction lacks commercial substance or neither the fair value of the assets received nor given up is reliably measurable (AASB 116, para 24). AAS 21 assumed that fair value can always be measured.
- Assets and parts of assets: AASB 116 does not prescribe the unit of measure for recognising assets; i.e. what constitutes an item of property, plant or equipment (PPE). Therefore, professional judgement is required to apply the recognition criteria to an entity (AASB 116, para 9). There is discussion regarding parts of assets, but parts of assets are not separate assets. Previously, AAS 4 para 5.7.3 required 'components' to be accounted for as 'separate assets.'
- Revaluation Reserves: *for-profit* entities must account for revaluation increments / decrements on an individual asset basis. This is a change from AASB 1041 which permitted the class of asset approach. However, as discussed above, AASB 116 does not prescribe the unit of measure for recognising assets; that is, what constitutes an item of PPE. An asset, not part of an asset, is the basis for accounting for movement in the asset revaluation reserve. *Not-for-profit* entities are to continue to use the class of asset approach (AASB 116, paras Aus39.1 and Aus40.1-Aus40.2).

2. NSW TREASURY *GUIDELINES FOR CAPITALISATION OF EXPENDITURE* (TPP 00-3)

The previous NSW Treasury Guidelines discussed in detail the concept of major periodic maintenance (MPM) and its accounting treatment. These revised Guidelines no longer refer to MPM. Instead, AASB 116 and the current Guidelines rely on the concept of the replacement of parts of assets and major inspection costs.

Previously, agencies were required to account for MPM in accordance with the 2000 Guidelines (TPP 00-3) as follows:

> "1. In order to reflect the pattern in which an asset's future economic benefits are consumed, agencies must recognise all material separately identifiable component assets that in effect represent the MPM and depreciate those assets over their shorter useful life …. In these instances, the MPM equates with the replacement of the component asset and must be capitalised. This includes circumstances where it can be considered that the:
>
> (a) MPM represents a readily identifiable component asset – eg the lining and housing of a blast furnace; and

(b) MPM does not represent a readily identifiable component asset; however, an 'artificial' component can be determined to represent the MPM – eg dredging of extra channel depth.

2. Where MPM cannot be separately identified as a component asset, the MPM must be expensed except to the extent that expenditure increases the asset's originally assessed standard of performance (see para 5.7, AAS 4 …)."

MPM was defined in the 2000 Treasury Guidelines as material (in monetary terms), cyclical in nature and incurred under a periodic maintenance plan (e.g. the overhaul of a power generation plant or a water treatment plant). In contrast, routine maintenance was maintenance of a regular and ongoing nature that was treated as an expense and would include day-to-day servicing costs in AASB 116, para 12.

MPM or major cyclical maintenance was previously discussed in UIG Abstract 26 *Accounting for Major Cyclical Maintenance*. UIG 26 prohibited provisions for MPM being recognised as a liability or as accumulated depreciation or as a reduction in the carrying amount of an asset. In effect, this overturned Treasury's 1994 Policy. Instead, UIG 26 stated that in many instances, MPM represented, or was equivalent to, the replacement of a component asset, as defined under the previous AAS 4. For this reason, the 2000 Treasury Guidelines discussed MPM and the different scenarios where MPM could or could not be recognised as a replacement of a component asset (as per (1) and (2) above).

However, UIG 26 has not been carried forward as part of AEIFRS. This is because AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* makes it clear that provisions for future maintenance costs must not be recognised as a liability. This means that the commentary to UIG 26, which discussed MPM that represents the replacement of component assets, is not included in the AEIFRS. Instead, AASB 116 discusses replacement of parts and the concept of major inspection costs. Major inspection costs represent labour costs only and are not equivalent to MPM, as previously defined by Treasury's Guidelines. Major inspection costs are further discussed in section 4.2.2. For this reason, the Guidelines no longer prescribe any specific accounting treatment for MPM.

The effect of AASB 116 is that major inspection (labour) costs are capitalised in the carrying amount of the asset, as a replacement, if the recognition criteria are satisfied. In contrast, under previous Treasury Guidelines (per (2) above), labour costs (and costs relating to the physical sub-component parts) associated with MPM that could not be separately identified as a component asset were expensed. In effect, this means that the labour costs associated with (2) above, that were previously expensed, can now be capitalised. However, the cost of the *physical* sub-components parts that cannot be separately identified as a component asset must continue to be expensed.

In summary, the accounting treatment outlined in (1) above has been replaced by AASB 116, para 13, which requires capitalisation of replacement parts, where the recognition criteria is satisfied. Therefore, there is no change in treatment in (1) above. However, the labour costs associated with (2) above must now be capitalised as a replacement, where the recognition criteria is satisfied, where previously they were expensed. The other part of (2) above, relating to the physical sub-components, continues to be expensed, and is treated as a 'day-to-day servicing cost' under AASB 116, para 12.