CIPFA The Chartered Institute of Public Finance & Accountancy

LAAP BULLETIN 86- *Update*

Componentisation of Property, Plant & Equipment

The Local Authority Accounting Panel issues LAAP Bulletins to assist practitioners with the application of the requirements of the CODE, SeRCOP and Prudential Code, and to provide advice on emerging or urgent accounting issues. Bulletins provide influential guidance that is intended to be best practice, but are not prescriptive and do not have the formal status of the CODE, SeRCOP or Prudential Code.

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INTRODUCTION

1 This Bulletin discusses the accounting issues under the IFRS-based *Code of Practice on Local Authority Accounting* (The Code),[1] for the separate recognition, depreciation and derecognition of parts of assets (often referred to as 'componentisation') under International Accounting Standard 16 (IAS 16) *Property, Plant and Equipment* (PPE).

2 The Bulletin examines the purpose of component accounting and provides some practical guidance for establishing a process which will enable significant components of an item of PPE to be properly identified.

3 The Local Authority Accounting Panel (LAAP) recommends that the process for componentisation, as set out below, should work most successfully when developed in partnership between an authority's **accountants** and **other key experts and/or professionals**. The professional background of the expert to be involved will depend upon the nature of the asset under consideration and its components. For the purposes of this Bulletin we are using the term '**other professionals**' to describe one of more of these professionals. It is for each authority to determine the extent of support they require from each of these other professionals at different times. In respect of land and buildings assets and components, the other professionals may mean one of more of the following; Valuers, Quantity Surveyors, Cost Planners, Building Surveyors, Architects, Mechanical & Electrical Engineers etc.

4 The '**accountant**' is a relevant finance officer appointed by the Chief Finance Officer.

5 The Bulletin is set out in two sections:

Section 1 discusses the purpose of component accounting and the Code's requirements for componentisation, and

Section 2 provides practical guidance to assist with the identification of significant components of PPE for separate valuation and depreciation.

6 This Bulletin is relevant to local authorities in **all jurisdictions**.

7 Guidance on the basis of valuation required for items of PPE and components of PPE is not provided in this Bulletin. Authorities are advised to refer to the Code (chapter 4) and RICS valuation standards for valuation guidance.

1 References in this Bulletin are made to the 2014/15 Code.

SECTION 1 – THE PURPOSE OF COMPONENT ACCOUNTING AND REQUIREMENTS OF THE CODE

Background

8 The requirement to componentise assets was previously included in the SORP (based on UK GAAP), in accordance with Financial Reporting Standard 15 (FRS 15).

9 The SORP required the separate depreciation of two or more major components of an asset (ie as if each component was a separate asset in its own right) where the useful lives were substantially different.

10 The Code follows the component accounting requirements set out in IAS 16. The Code places a much greater emphasis in this area and defines components that require to be depreciated separately in the context of those having a *'cost that is significant in relation to the total cost of the asset'*.

11 This increased emphasis regarding componentisation under the Code meant that authorities that had previously not separately depreciated components of PPE were required from 2010/11 to establish an accounting policy for the componentisation of their assets and to apply that policy as assets are acquired, enhanced[2] and revalued.

12 Authorities need only follow these requirements where **significant components** of **material items of PPE** (assets) have been identified. This is discussed in more detail in paragraphs 54.1–56.11 below.

13 The guidance included in **section 2** of this Bulletin should assist authorities to develop procedures for component accounting that can be applied when componentisation of an item or items of PPE is first required.

The Purpose of Component Accounting

14 The objective of component accounting is to follow proper accounting practice by ensuring that PPE is accurately and fairly included in an authority's Balance Sheet and that the Comprehensive Income and Expenditure Statement properly reflects the consumption of economic benefits of those assets (ie the cost of their use) over their individual useful lives, through depreciation charges.

15 In order to achieve this objective, authorities must ensure that the overall value of an asset is fairly apportioned over significant components that need to be accounted for separately and that their useful lives and the method of depreciation are determined on a reasonable and consistent basis. The authority's accountants and other professionals are required to use their professional judgement to meet this objective.

[2] ie **subsequent expenditure** that meets the criteria in paragraphs 4.1.2.16 and 4.1.2.17 of the Code

Component Accounting Requirements under the Code

16 The Code, in paragraph 4.1.2.40, prescribes that:

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 shall be depreciated separately. Where there is more than one significant part of the same asset which have the same useful life and depreciation method, such parts may be grouped in determining the depreciation charge.

17 In practice, Code requirements can be satisfied by separately accounting for only those significant components that have different useful lives and/or depreciation methods to the remainder of the asset (see paragraph 4.1.2.40 of the Code). Therefore, the provisions only need to be applied to the extent that an authority can assure itself that depreciation charges are materially correct.

IAS 16 states that:

To the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant [for depreciation purposes]. If an entity has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of its parts.

18 Where a component is replaced, the carrying amount of the old component shall be derecognised to avoid double counting and the new component reflected in the carrying amount, subject to the recognition principles of capitalising expenditure (set out in paragraph 4.1.2.16 of the Code) being met. Such recognition and **derecognition** takes place regardless of whether the replaced part has been depreciated separately (see paragraph 4.1.2.19 of the Code).

19 **Derecognition** of a component of PPE takes place when no future economic benefits are expected from its use (ie its service potential is used up) and it is removed from the Balance Sheet.

20 Where it is not possible to determine the carrying amount of the replaced part of an item of PPE, authorities may use the cost of the new part to estimate what the cost of the replaced part was at the time it was acquired or constructed (see paragraph 4.1.2.48 of the Code).

21 **Land and buildings are separate assets and must always be accounted for separately, even when they are acquired together (paragraph 4.1.2.37 of the Code).**

22 Authorities should note that, although the depreciation aspect of component accounting is not relevant to Investment Properties (there is no requirement to depreciate Investment Property), component accounting will apply in respect of the recognition and

derecognition of components when subsequent expenditure is incurred (see paragraph 4.4.2.10 of the Code and IAS 40).

23 Componentisation also applies to assets recognised under IFRIC 12 (Service Concession Arrangements) and IAS 17 (Leases).

Impact of Transitional Provisions [up to 31 March 2015]

24 The Code gives a concession in only requiring componentisation for depreciation purposes to be applied from 1 April 2010. Authorities cannot choose to apply the IFRS provisions retrospectively (refer to Paragraph 4.1.1.6 of the Code). However, where authorities ha used component accounting prior to 1 April 2010 they continued to do so.

25 The Code's **prospective** requirements are applicable to:

enhancement[3] expenditure incurred,

acquisition expenditure incurred, and

revaluations carried out

on items of PPE with effect from 1 April 2010.

26 As discussed in paragraphs 8 and 9 above, the Code's predecessor publication the SORP adopted component accounting. The accounting treatments applied in calculating depreciation before the implementation of IFRS might thus not be substantially different from those required under the Code for 2010/11 or future years. The pragmatic decision not to apply the Code's requirements for componentisation retrospectively was taken by CIPFA/LAASAC on the basis that such retrospective application was not expected to have a material impact on authorities' accounts.

27 The exemption from retrospective application might therefore have little practical effect for many authorities. It will probably only have a substantial effect where an authority did not separate major components before 1 April 2010. If that is the case, the Code's implementation provisions would potentially result in an inconsistency in depreciation calculations that will be carried forward until the assets implicated are enhanced or revalued.

28 Authorities in these circumstances will need to take care in setting out their accounting policies and drafting notes to the accounts so that readers can understand the effect of the Code's prospective provisions for component accounting, ensuring that the inconsistency referred to above is adequately explained. Authorities might also consider including further explanation in the non-current asset note.

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[3] See footnote 2 above

SECTION 2 – PRACTICAL APPLICATION OF THE CODE'S REQUIREMENTS FOR COMPONENT ACCOUNTING

Introduction and General Information

29 The rationale behind componentisation is straightforward. It is not always the case that component parts of a non-current asset have the same useful lives. Furthermore, they may wear out or depreciate at different rates throughout their life or have a high risk of impairment or obsolescence. Therefore, it is appropriate to depreciate each significant component separately over its useful life, in order that the Comprehensive Income & Expenditure Statement is fairly charged with the consumption of economic benefits of those assets.

30 Where a significant component is expected to wear out more quickly than the overall asset, it is depreciated over a shorter period and any subsequent expenditure on restoring or replacing the component is capitalised (with any carrying amount of the replaced component being written off to the Comprehensive Income and Expenditure Statement).

31 The following is an illustration of the concept of component accounting. The principles, rather than the specifics, should be applied to an authority's assets.

ILLUSTRATION: COMPONENT ACCOUNTING

An authority's leisure pool is a material asset. It contains a significant amount of plant and equipment (pumps, filters, slides, wave-making machine, etc) which have a useful life which is substantially shorter than the structure of the property. It is therefore necessary for the authority to, as a minimum, recognise two components, the structure and the plant and equipment. If one or more components of the structure have a significantly different life to the remainder of the property or one or more items of plant and equipment have a significantly different life to other items of plant and equipment, then further analysis into component parts will be required.

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32 As discussed in paragraph 16 above, the Code requires that each part (component) of an item of PPE (asset) should be separately identified and depreciated where the cost of that component is significant in relation to the overall cost of the asset. It should be noted that the cost of an asset may be different to its carrying amount. Cost is examined in more detail below.

33 When the significant parts of an item of PPE that have different useful lives and/or require different depreciation methods are identified, there is no requirement to then

separately identify any other components of that asset. The remaining elements of the asset can be grouped together and depreciated in accordance with their similar useful lives and similar methods of depreciation.

34 **Where the cost of assets and components cannot be identified, best estimates will be required**.

35 Where similar items of PPE are recorded in groups, it may be possible to identify significant components by the use of sample testing. This will identify typical components with differing useful lives or different depreciation methods within the groups of assets.

36 Authorities should have established the principles for component accounting and introduced agreed procedures so that when they are first required to apply component accounting, eg where subsequent[4] expenditure is incurred, new items of PPE are acquired (ie before a full review of PPE for component accounting) or assets are revalued, the agreed procedure can be applied and followed consistently.

Doing More than the Minimum

37 An authority may choose to apply component accounting voluntarily to all of its PPE assets, rather than just the material ones.

38 Furthermore, authorities may choose to separately identify and account for significant components of a non-current asset even though they have **similar lives** and the **same method of depreciation**. This will enable the **net book value** (carrying value) of a component to be easily identified and written off to income and expenditure when it is replaced or restored and to capitalise the expenditure incurred on restoring it. Also, under IAS 16, an authority may choose to depreciate separately the parts of an asset that do not have a cost that is significant in relation to the total cost of the asset.

Determining the Carrying Amount of a Replaced Component

39 Where it is not possible to determine the carrying amount of a replaced component, authorities may use the cost of the new component as an indication of what the cost of the replaced component was at the time it was acquired or constructed, adjusted for depreciation and impairment if required (see paragraph 4.1.2.48 of the Code).

40 Therefore, where a component has been recognised as significant but the depreciated historical cost of the original component is not known, it should be estimated using a reasonable basis. This may involve using the replacement cost of the component, discounted back to the original component's inception and adjusted for any subsequent depreciation and impairment. It is important to maintain adequate records to support

[4] See footnote 2 above

such calculations.

Asset Registers

41 It is essential that non-current asset registers are reviewed and adapted where necessary, to ensure that they can meet the Code's requirements. As a minimum, asset registers should include sufficiently accurate records to comply with financial reporting requirements, which will include the ability to separately record significant components of a non-current asset or group of assets for valuation, subsequent expenditure, depreciation and derecognition purposes. The register can be used to inform the accountant of any significant components.

42 It is important that authorities maintain a comprehensive non-current asset register which enables them to exercise sound asset management over their PPE and other assets held. The non-current asset register will, amongst many things, assist the authority in its asset management planning, property management and maintenance. The degree of comprehensiveness, definition of assets and the amount of information held on the asset register is a decision that each local authority must make. The asset management system will frequently include much more detailed information about assets than that required for the purposes of component accounting.

Identification Process

43 It is essential that accountants and other professionals work jointly to properly determine the typical types of significant components relevant to the assets of the authority, to establish how these assets will be identified during the normal course of replacement and how their value will be determined.

44 Professional judgement will need to be exercised by the authority's accountants and other professionals to achieve realistic and robust valuation of componentised assets that comply with the Code's requirements. Establishing materiality levels, identifying significant components and determining their useful lives are typical areas where ongoing professional judgement will be required.

45 Authorities should establish and document clear and concise procedures, communicated to all relevant staff, that will enable them to identify significant components of a non-current asset; to establish the value of such components and to determine an appropriate depreciation charge which reflects the consumption of the economic benefit of the component. The procedures should include a requirement to **document assumptions and the basis on which estimates are made**.

46 Component accounting policies should be reviewed regularly to ensure that they continue to provide a 'true and fair view' of the authority's consumption of economic benefits, in line with the Code's requirements.

47 The following section sets out practical guidance towards the successful implementation of this process and identifies the key experts that are required to be involved and at what stage their involvement is required.

Guidance for Establishing Component Accounting Procedures

48 Practitioners should note that even if the cost of a component is significant in relation to the total cost of an item of PPE, from an accounting perspective, it is not necessary to identify the value of that component if its useful life and required method of depreciation is in line with the overall asset.

49 In addition, componentisation of an item of PPE is not required where depreciating the item as a single asset is unlikely to result in a material mis-statement of either the depreciation charges or the carrying amount of PPE. However, authorities will need to collect the evidence required to demonstrate that a material mis-statement is unlikely.

50 Authorities were required to apply componentisation for the first time when assets were enhanced, acquired or revalued on or after 1 April 2010. Component accounting applies equally to assets carried at historical cost and not just those measured using the revaluation model.

51 The identification of components might normally take place as part of the overall arrangements for valuing PPE. However, it might sometimes be necessary to carry out particular reviews, perhaps when a substantial new asset is recognised for the first time. Therefore, it is essential that the principles for component accounting are established together with agreed and documented procedures which will facilitate this process. The stages in establishing procedures for component accounting are set out in the following sections .

52 The accountant will need to involve other professionals in determining and implementing the policy relating to component accounting. Arrangements should therefore be established to ensure that the other professionals likely to be involved in the process are familiar with the Code requirements relating to components of items of PPE. Arrangements should also be made for regular liaison throughout the process to ensure that other professionals agree that the policies established are appropriate and robust.

53 It is for the Responsible Finance Officer (RFO) to determine appropriate accounting policies, de-minimis levels, etc. The role of the auditor is to establish whether those policies are appropriate and do not result in material misstatements in the financial statements. Accountants are therefore encouraged to keep auditors informed of proposals and give the auditor an opportunity to make comments.

54 **Step 1 – Establishment of appropriate de-minimis thresholds.**

54.1 The need to identify component items of PPE will be influenced by the concept of materiality. **The accountant** must therefore consider the materiality of the impact upon the reported cost of service and carrying values of PPE in determining the levels of significance for recognition of components and in establishing robust de-minimis thresholds.

54.2 These de-minimus thresholds are used to identify individual assets that can be disregarded for componentisation.

54.3 The accountant may wish to involve other professionals during this process, in order to produce an agreed and robust approach.

54.4 Once established, the threshold should be documented, used appropriately and applied consistently.

55 Step 2 – Assessing the materiality of items of Property, Plant and Equipment

55.1 Prior to establishing the policy which will be used to determine which components will be recognised and depreciated separately (see step 3 below), accountants should have a thorough understanding of the authority's asset base. This will enable them to identify material assets with significant components that require separate recognition.

55.2 This process will involve the accountant carrying out a review of the authority's existing assets in PPE to identify:

i) Individual assets that are below the de-minimis level and which can be disregarded for componentisation on the basis that any adjustment to depreciation charges would not be material.

Note that groups of similar assets that **individually** are below de-minimis for componentisation may **collectively** be material for componentisation – see iii) below.

ii) Individual assets that are above the de-minimis level and require consideration of whether they contain significant components which have different useful lives and/or methods of depreciation to the overall asset.

If it is the case that significant components with differing useful lives and/or methods of depreciation are identified, the resultant depreciation charges for the componentised asset may differ materially from the depreciation charges had the asset not been componentised.

iii) Groups of similar assets may be sample tested so that typical components with differing useful lives or methods of depreciation (eg straight line or reducing balance) can be identified.

It may be possible to make a reasonable assumption that such component types are typical for the asset group and the assumptions can therefore be applied to all assets in that particular group.

55.3 When assessing the materiality of **individual assets** relative to **overall assets**, it may be more practical to use **carrying values** (instead of cost), as a basis upon which to determine materiality.

55.4 **Accountants should use their judgement when considering which items of PPE are material.**

55.5 It is essential that the basis upon which accountants determine materiality, including any assumptions or estimates made, are clearly documented and supported by calculations or other relevant information to assist other colleagues and auditors to understand how levels of materiality were determined. This process will set the criteria to be included in the authority's procedures for identifying material items of PPE going forward.

56 **Step 3 – Setting the principles for componentisation:**

56.1 **The accountant** should establish **the principles** which will be used to determine which components will be recognised and depreciated separately.

56.2 When setting the policy accountants should bear in mind that Code requirements can be satisfied by separately accounting for only those significant components that have different useful lives and/or depreciation methods to the remainder of the asset (see paragraph 4.1.2.40 of the Code).

56.3 Having identified individual material assets or asset groups that require review in accordance with agreed de-minimis thresholds, **the accountant** should now begin to establish **the principles** upon which components should be recognised (eg significance, useful lives and depreciation methods) and depreciated separately, in accordance with the appropriate thresholds for **recognising** separate components.

56.4 As discussed earlier, the Code requires that each part (component) of an item of PPE should be separately identified and depreciated where the cost is significant in relation to the overall total cost of the asset. Cost is defined as the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of acquisition or construction (see paragraph 4.1.2.3 of the Code). Note this is not the proxy for cost as at 1 April 2007 (1 April 2008 for Northern Ireland), when the Revaluation Reserve was established. When comparing the cost of a component against the overall cost of the asset it is essential that the assessments are made as at the same date. See paragraph 56.6 below for further guidance in this area.

56.5 Where an authority's historical cost of assets and components cannot be established, best estimates will need to be determined by the accountant in conjunction with other professionals, as appropriate. The best estimate may be determined by reference to the current cost**.**

56.6 The policy needs to specify the basis on which it will be determined whether the cost of a component is significant in relation to the overall asset. The policy is likely to refer to the cost of the component as a proportion of the overall cost of the asset rather than an absolute amount. Determination of the policy may be assisted by the accountant and other professionals identifying typical components for each asset type or group of assets. In other words, the significance of a component relative to the overall asset, will be determined for each situation as follows:

- **When subsequent expenditure is incurred on an asset:** the cost of the replacement component is compared with the cost of the total asset and the result is measured against the agreed de-minimis threshold.
  To establish whether a new replacement component (of a material asset) is significant and qualifies for separate recognition, it is essential that when comparing its cost against the cost of the overall asset (which will include that new component) that the assessments are made as at the same date. This may mean estimating the current-day build cost of the asset (including the new component) and comparing the cost of the new component against that cost. Alternatively, where an authority holds original cost information, the significance of a new component may be achieved by discounting back its new cost to the date when the asset was initially recognised and comparing that adjusted cost against the original cost of the asset .
  The carrying amount of the old component must be derecognised to avoid double counting.
- **When an asset is acquired:** the **cost** of any component parts are compared with the overall **cost** of the new asset and the results assessed against the agreed de-minimis threshold.
- **When an asset is revalued:** the **cost** of the component part is measured against the **cost** of the total asset and the result compared with the agreed de-minimis threshold. As stated above, ensure that the assessments are made as at the same date.

In summary, the significance of a component relative to the overall asset will be determined by comparing the **cost** of the component under review against the overall **cost** of the asset on a comparable basis and assessing the result against the agreed de-minimis threshold.

56.7 Having established the criteria for identifying significant components the accountant should, with other professionals, as appropriate, consider whether a difference in useful life and/or depreciation method would, for the typical assets of the authority, have a material impact on the level of depreciation and/or carrying value of the item of PPE. This will enable the policy to contain guidance regarding the items of PPE that are likely to need analysing into component parts. However, the policy must be capable of being applied to all items of PPE.

56.8 Although a component might be significant in relation to the total cost of an item of PPE, from an accounting perspective, it might not need to be recognised for separate depreciation if the component's useful life and required method of depreciation is in line with the overall asset, unless the authority decides to separately identify such a component for asset planning (eg for future replacement or restoration purposes or for Investment Properties).

56.9 There may be circumstances where similar components that have substantially different useful lives to the overall asset exist in a large number of similar assets. On an individual asset basis they might not be material, but when considered collectively in terms of the number of similar assets, the impact on depreciation charges may be material and consequently they should be separately depreciated.

56.10 Based on the above, the accountant and other professionals should jointly decide typical types of components for each asset type or group of assets that are likely to meet the above criteria. The procedures should make clear that such information is for guidance only.

56.11 Once again, accountants will need to use their judgement when establishing the policy for analysing items of PPE into component parts. Any assumptions or estimates made must be clearly documented and supported by calculations or other relevant information.

57 Step 4 – Accountant to discuss the principles for componentisation with other professionals.

57.1 The accountant should meet with other relevant professionals to discuss the basis upon which significant items have been identified for possible componentisation. This will ensure that all relevant professionals are made aware of:

- the de-minimis thresholds established at step 1 above;
- the assets or groups of assets that the accountant considers significant for review by the other professionals, and
- the principles for determining components.

57.2 The accountant needs to clearly explain to other relevant professionals that the primary purpose of componentisation is to assist the calculation of depreciation within material bounds. This will ensure that items of PPE that:

- are below agreed de-minimis thresholds, or
- have similar useful lives and/or methods of depreciation

are not separately, and unnecessarily, recognised for depreciation .

57.3 Having considered the above criteria, the accountant may however be advised that additional components should be separately identified for asset planning (eg for future replacement or restoration purposes).

58 Step 5 – Relevant other professionals to determine useful lives of significant components

58.1 The relevant other professional/(s) needs to assess the individual useful lives of the significant components in each asset or asset group within PPE identified in accordance with step 3 above in line with the agreed de-minimis thresholds and the principles for componentisation.

58.2 This is where the other professionals will exercise their professional judgement. A general principal will be to identify those significant parts of the asset that will require restoration or replacement before the end of the overall asset's useful life, and to treat such items as components for separate depreciation.

58.3 The procedures should prompt other professionals to clearly document and support any assumptions or estimates made.

58.4 A review of the asset management system (or discussions with the asset management team) will provide the relevant information to enable other professionals to assess the physical condition of components and consequently their useful lives.

58.5 The method of depreciation that best suits the significant component will be agreed with the accountant and consistently applied.

59 Step 6 – Attributing Values to Significant Components

59.1 Component accounting will require both the accountant and the other professionals to use their professional expertise/judgement to fairly apportion the value of items of PPE over significant components that have been recognised for separate depreciation.

59.2 Both the accountant and other professionals must ensure that accurate and realistic valuation (cost estimations) of components is carried out. This will ensure that the authority's accounts include accurate depreciation charges so that its services are fairly and accurately charged with the cost of the assets they use.

59.3 Balances on the Revaluation Reserve will be recorded by asset, with separate balances for the land and buildings elements of an asset. When the building element is separated into different components, authorities will need to consider whether the Revaluation Reserve balance for the building should be allocated across the various components that are recognised.

59.4 The Local Authority Accounting Panel considers that, in most cases, it would be appropriate to recognise any Revaluation Reserve balances as relating to the structure of the building (whether this is one component or a number of components), and that the plant and equipment components are unlikely to give rise to revaluation gains and losses independently of the structure of the building. However, the plant and equipment components may be subject to impairment.

59.5 Once an authority has established an accounting policy for allocating Revaluation Reserve balances across components, it should apply this policy consistently to both existing balances, and any revaluation gains or losses that arise in future.

59.6 The sum of the individual values of components must agree with the overall value of the asset.

Practical Application of the Principles of Component Accounting

60 This section suggests how the processes and guidance outlined above might be applied in practice in respect of:

- subsequent expenditure[5] (to add to or replace a part of PPE);
- acquisition of PPE; and
- revaluation of PPE.

Subsequent expenditure – overview

60.1 Subsequent expenditure is incurred on an individual item of PPE when:

- a **new component** is added to the asset,
- an **existing component** of the asset is **refurbished or upgraded**, or
- a component of the asset is **replaced**.

60.2 Where any of the above situations arise and the expenditure qualifies as capital expenditure, the authority will first need to establish if the **item of PPE** (asset) has been identified as **material**, following the accountant's overall review of the authority's PPE conducted at step 2 above.

60.3 If the item of PPE was originally considered immaterial the accountant will however need to establish if the subsequent expenditure requires them to re-assess the materiality of the enhanced item of PPE, relative to the authority's overall assets. If the item of PPE remains immaterial, it can continue to be disregarded for componentisation, as any adjustment to depreciation charges will not be significant.

60.4 If the item of PPE is material, any new; replaced or enhanced component should now be reviewed to establish whether it is significant relative to the item of PPE. Where this is the case, the authority must next ascertain whether the component's useful life differs to that of the overall asset, or it requires a different method of depreciation, in which case it will be separately recognised (refer to step 3 above).

Subsequent expenditure – other practical considerations

Derecognising an old component

60.5 When a component is replaced, the Code requires that the carrying amount of the old

[5] See footnote 2 above

component is derecognised and the new component reflected in the carrying amount of the overall asset (subject to capitalisation principles). This may require using the cost of the new part as an indication of the historical cost of the replaced part. (Note that this is required irrespective of whether the replaced part has been previously separately recognised as a component).

60.6 As previously discussed, when a component has been recognised as significant and the carrying value of the original component is not known, it should be estimated using a reasonable basis which may involve using the replacement cost of the component, indexed back to the original component's inception and adjusted for any subsequent depreciation and impairment.

60.7 Where a component that has not been separately accounted for is replaced (eg an annex to a building), authorities will need to consider whether a portion of any balance on the Revaluation Reserve relates to that component (in line with the guidance given in paragraphs 59.3 to 59.6 above). Where this is the case, the relevant portion of the balance on the Revaluation Reserve will be eliminated as part of the derecognition process. Replacement of a component that has been separately accounted for will be simpler, as any balance on the Revaluation Reserve for the component will be separately identifiable. Again, this amount will be eliminated as part of the derecognition process.

60.8 It is likely that those authorities that already applied component accounting (prior to 1 April 2010) will have recognised significant components, therefore enabling their existing carrying values to be more easily identified when replacement or adaption takes place.

Recognising a replacement component

60.9 As discussed in Step 3 above, to establish whether a new component is significant, it is essential that when comparing its cost against the cost of the overall asset that the assessments are made as at the same date. This may mean estimating the current-day build cost of the asset (including the new component) and comparing the cost of the new component against that cost. Alternatively, where an authority holds original cost information, the significance of a new component may be achieved by discounting back its cost to the date when the asset was initially recognised and comparing that adjusted cost against the original cost of the asset.

60.10 Where expenditure on a new replacement component meets the code's capitalisation criteria, it is normally added to the carrying amount of the relevant asset. Generally, the amount paid should provide a fair measure of the future economic benefits or service potential that will flow to the authority. There is no requirement to revalue the asset in these circumstances, unless the authority has indications that the asset might be impaired . If the component is significant it will be depreciated separately.

60.11 After initial recognition, plant and equipment components will continue to be held at

Depreciated Historical Cost (except where impairment is indicated) unless the situation described in the next section exists.

Subsequent / replacement expenditure that does not increase the carrying value of an asset carried at fair value

60.12 It may be the case that, even though a new or replacement component meets the Code's capitalisation criteria in paragraph 4.1.2.16 and it is significant, it does not necessarily increase the carrying value of an item of PPE carried at fair value. There is no specific requirement in the Code to confirm whether this is the case by obtaining a new valuation, other than the general provision that carrying amounts in the Balance Sheet are materially correct. Alternatively, the replacement process might provide evidence that the asset could be impaired (see paragraphs B37 and B38 in Module 4 of these Code Guidance Notes).

60.13 Where there is reasonable scepticism that a new or replacement component has not increased pound for pound the carrying value of the asset, practitioners will wish to discuss with their relevant professionals whether a formal revaluation is needed.

60.14 Where it is judged that a revaluation is needed, the asset's carrying amount (which includes the subsequent expenditure) will be reduced and the decrease charged to either the Revaluation Reserve or the relevant Cost of Service line in the Comprehensive Income and Expenditure Statement (CIES) as a revaluation loss (to the extent that there is no remaining balance on the Revaluation Reserve). See paragraph 4.1.2.34 of the 2014/15 Code and paragraphs C72 and C73 of Module 4 in these Guidance Notes.

A new component is added

60.15 Where a new component is added to an item of PPE (ie the new component did not previously exist or is not replacing an old component) the cost will be added to the carrying value of the existing asset. If the new component qualifies for separate recognition it is depreciated over its useful life and/or separate method of depreciation.

60.16 For example, the cost of adding a new wing to an office building should be capitalised as it will meet the recognition criteria of the Code. The additional rooms increase the service potential of the property and the cost of the increase can be measured reliably. If the new component qualifies for separate recognition it is depreciated over its useful life and/or separate method of depreciation.

Acquisition of a new item of PPE that qualifies for recognition as an asset

60.17 When a new item of PPE is acquired or constructed, the accountant will need to establish whether it is material relative to the authority's overall assets, in accordance with the agreed thresholds established at step 2 above.

60.18 If the new item of PPE is material, the accountant and other professionals will need to identify any significant components that might need to be separately recognised, by applying the principles discussed in step 3 above of the practical guidance.

60.19 The new item of PPE will be initially measured at its cost (see paragraphs 4.1.2.20 and 4.1.2.22 of the Code). The method by which the cost of the new asset is apportioned over significant components will require both the accountant and other professionals to use their professional expertise. As discussed earlier, assumptions and estimates used in this process should be clearly documented.

60.20 By having an agreed procedure for component accounting in place, componentisation of new items of PPE can be undertaken in a consistent and structured way to ensure that depreciation charges for such new assets are properly calculated in line with the Code's requirements.

Revaluation of assets

60.21 **The accountant and valuer should establish the basis of valuation appropriate to an individual item of PPE. The bases of valuation used must follow the requirements of the Code.**

60.22 **Whether valuations are provided by an internal or an external valuer, valuations for inclusion in local authority accounts are provided in accordance with UK PS 1.12 and UK Appendix 1.5, and must comply with the RICS Valuation Standards (The Red Book).**

60.23 **Having identified the appropriate valuation basis for an item of PPE, the authority's valuer will value it in accordance with Code requirements and their own professional standards.**

60.24 When the required valuation for an item of PPE has been established, the other professionals will be needed to apportion that value over the significant components already recognised for separate depreciation. The judgement of the other professionals is required to determine the most appropriate method by which such apportionment can be carried out. The guidance provided in paragraphs 59.3 to 59.6 above may assist in this process.

60.25 As discussed earlier, accurate and realistic valuation (cost estimation) of components is necessary to ensure that the authority's accounts include accurate depreciation charges, so that its services are fairly and accurately charged with the cost of the assets they use.

Materiality – further practical considerations

60.26 This LAAP Bulletin (and the Code Guidance Notes) assist authorities, through the application of materiality, to determine whether or not to componentise items of PPE. However, having determined that component accounting is needed, materiality still has relevance in the level of detail to which the Code must be applied which may enable authorities to use a simplified process. Provided that materially accurate depreciation charges are achieved, there is scope to use estimates and simplify calculations in preparing those charges.

60.27 Where authorities consider that there is an opportunity to use a simplified process towards component accounting they might wish to discuss such an approach with their auditors.

Conclusion

61 Component accounting requires, as a minimum, the separate identification of significant components of an item of PPE that have different useful lives or require different methods of depreciation relative to the overall asset.

62 When significant components of an item of PPE, that have separate useful lives and/or require different depreciation methods to that of the overall asset, have been identified (eg lifts and heating system), what remains is also a component (eg the structure of the building).

63 Where a component is replaced, the Code requires that the carrying amount of the old component shall be derecognised (to avoid double counting) and the new component reflected in the carrying amount of the overall asset (subject to capitalisation principles). This may require using the cost of the new part as an indication of what the cost of the replaced part was at the time it was acquired or constructed. This is required, regardless of whether the replaced part has been previously separately recognised as a component.

64 Although the depreciation aspect of component accounting is not relevant to Investment Property, component accounting will apply in respect of the recognition and derecognition of components when subsequent expenditure is incurred (see paragraph 4.4.2.10 of the Code).

65 Componentisation applies to assets recognised under IFRIC 12 (Service Concession Arrangements) and IAS 17 (Leases).

66 The Bulletin emphasises that it is essential for the authority's accountants and other professionals to work jointly to develop a robust process to identify significant components of non-current assets for valuation, depreciation and replacement purposes. It is essential that any assumptions and the basis on which estimates are made by accountants and other professionals during the process are clearly documented.

67 Accountants and other professionals are required to use professional judgement when establishing significance levels, assessing the useful lives of components and apportioning asset values over recognised components. Discussions with external auditors should be held at key stages during this process.

68 Materiality still has relevance in the level of detail to which the Code must be applied which may enable authorities to use a simplified process for componentising non-current assets. Provided that materially accurate depreciation charges are achieved, there is scope to use estimates and simplify calculations in preparing those charges.

69 The above principles apply to all items of PPE assets and heritage assets.