

Inappropriate Recognition of PPE

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Introduction

LMN Company is a leading company which operates in the manufacturing industry. The company manufactures and sells aluminum extrusions. Sales of the company are carrying out by sales outlets and dealers, and also the company export the extrusions as well.

The company manufactures extrusions in their own manufacturing plants, therefore the company possesses significant amount of non-current assets which are categorized in to various classes of assets.

The company require huge amount of power to operate their machines. They can't satisfy with the electricity supply which received from general electricity line. Therefore LMN Company has established a transformer in their factory premises after entering the agreement with Ceylon Electricity Board (CEB).

Analysis of the Issue

The transformer has been established in the LMN factory premises. The company has recognized that established transformer as their asset under Property Plant & Equipment. But the controlling power of the transformer is with Ceylon Electricity Board & direct future economic benefits are also generated towards the CEB but not to the LMN Company since company is paying electricity bill to the CEB. LMN Company cannot sell the transformer to the third party or cannot transfer the agreement to the third party. Agreement period is for the 7 years and that is the useful life time of the transformer. Company depreciate the transformer by 10% since it is under the category of Plant & Machinery.

According to the LKAS 16 following criteria must be satisfied in order to recognize as a PPE.

- It is probable that future economic benefits associated with the item will flow to the entity.
- The cost can be measured reliably

This is also has been discussed under **IFRIC 18 Transfers of Assets from customers** in the side of Ceylon Electricity Board. In that case IFRIC 18 has elaborated this under the heading of "**Is the definition of an asset met?**" Here the standard has emphasized main factors that should be considered to satisfy the definition of the asset.

Controlling power of the asset

Though the ownership is not transferred to the customer, if the customer can controls the asset & the asset is exist, customer can recognize it as an asset if

other requirements are satisfied. On the other hand Supplier (Ex: CEB) can't recognize this as asset despite a transfer of ownership. But if controlling power is with CEB it can be recognize as their asset.

Future Economic Benefits

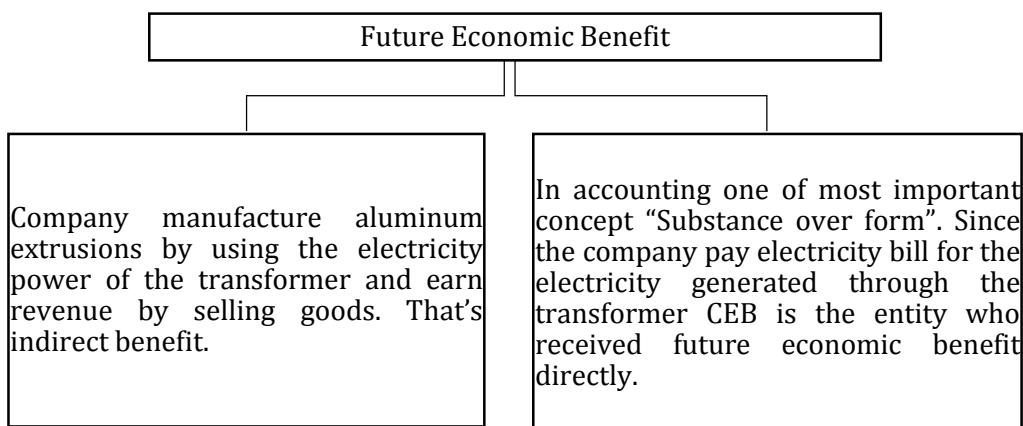
If the entity has power to control the future economic benefits of this item, then it can be recognized as an asset. Here C: E: B can control the economic benefits. They are paid electricity bill by the company. At any time C: E: B can change their rates for the electricity.

Who is responsible for the operation & maintenance of the asset?

Whether supplier or customer responsible for the maintenance & operations of the transferred asset. LMN is not responsible for the maintenance of the transformer since it is a high power item. Responsibility to maintain the asset is with CEB.

Here in accordance with IFRIC 18 also the LMN Company can't recognized the transformer as their asset. It is an asset of Ceylon Electricity Board since controlling power & future economic benefits are with CEB.

Some one can argue that there is future economic benefits to the company from the transformer. But that are indirect benefit.



So this transformer does not meet requirements of LKAS 16. Hence the LMN Company Can't recognize the transformer as an asset under PPE.

Implications of the Issues

Implication to the Income Statement

It is estimated that the transformer has been depreciated over the years and resulted to understate the profit and overstate the assets of the company.

Implication to the Statement of Financial Position

There is a classification change in the Statement of Financial Position.

Recommendations

The transformer cannot be recognized as an asset and recognize as a deferred asset.

Deferred asset is an expenditure that is made in advance, and is not yet consumed. The expenditure is made in advance, and the item purchased is not expected to be fully consumed until a large number of reporting periods have passed. In this case, the deferred asset is more likely to be recorded as a non-current asset in the Statement of Financial Position.

Deferred asset amortize over the useful life time (Agreement Period). It should be passed the following entries to rectify the errors.

At the time of purchasing

Deferred Asset Account – Dr
Cash/Bank Account – Cr

When amortizing the amount relevant for the year

P & L Account – Dr
Deferred Asset Account –Dr

Following Adjustments to be made to correct the issue

Deferred Asset – Dr	Retained Earnings – Dr
PPE – Cr	Deferred Asset – Cr
(Transferring Cost from PPE)	(Relevant Depreciation Amount amount)