

Non- Recognition of Capital and Revenue Expenditure

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Introduction

The NOP Lanka Ltd is a manufacturing organization and their prime activity is recycling of lead acid battery scrap and smelting of lead concentrate to produce lead ingots and polypropylene chips. For the production Battery scrap is collected from all over the country. NOP Lanka has 600 ton production capacity of led ingot per month.

In NOP Lanka, They use major plant to recycling, lead heating, smelting the lead and after certain time company replaced the major components of the plant during the period. In this case study it has been discussed whether these expenses come under capital nature or recurring expenses.

Discussion of the Issue

In the current year the NOP Lanka (Pvt) Ltd has recorded a lower profit than previous years. In the additions, there were major parts that added to the plant not recorded as capital nature expenditure that physically seen by the auditors. According to observation auditors could identify that repair and maintenance cost has increased significantly compared to previous years. According to further analysis auditors recognized, that amount use to replace the major parts of the plant has charged to maintenance cost and affect to decrease the considerable profit. Due to this replacement, useful life of the machine has increased for another four years. Further there is a value for the removed parts of the plant. However according to the LKAS 16 paragraph 13 says,

“Parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe. Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a nonrecurring replacement. Under the recognition principle in paragraph 7, an entity recognizes in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognized in accordance with the de recognition provisions of this Standard.

Therefore it is required to determine whether the amount that used to buy parts capitalized or not.

Accordingly as per the further observations by checking vouchers and nature of the asset, it was found it is capital nature expenditure due to the provision of LKAS 16 – Property Plant & Equipment.

Implication of the Issue

The NOP Lanka Ltd has recognized the replacement of major item of the plant that use to lead heating as an expense it has effected on the NOP Lanka's profitability as well as financial position of the company. The profitability is reduced because of changing capital expense as a recurring expenses. On the other hand the NOP's financial position is underestimated because of not recognizing replaced cost as capital nature expenditure.

Conclusion and Recommendation

According to LKAS 16 paragraph 13 Property plant and equipment parts of some items of asset required for some replacement that less frequently can capitalize If the replacements cost of that asset meet the recognition criteria's given by LKAS 16 under the paragraph 7 as follows;

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

In NOP Lanka because all this replacement of items f plant useful life again increased for another four years. Therefore this replacement cost should recognize as capital nature expenditure. But carrying amount of the existing parts that are replaced should derecognized in accordance with the de recognition provisions.

According to LKAS 16 paragraph 70“an entity recognizes in the carrying amount of an item of property, plant and equipment the cost of a replacement for part of the item, then it derecognizes the carrying amount of the replaced part regardless of whether the replaced part had been depreciated separately. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.” Therefore depreciation rate should change according to the useful life of the new parts.

Further according to the standard paragraph 71 gain or loss arising from the de recognition of an item of property, plant and equipment should determine as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

The receivable on disposal of an item should recognize its fair value and should identify as cash price equivalent.

Accordingly the Accounting treatment in this scenario is, firstly reverse the recognized recurring expenses from repair and maintenance, then record to as assets under the plant and machinery category and for the disposal loss or gain that arise from existing parts should be identified as cash price equivalent .