Guidance on depreciation of building components

# Background

Accounting Standards prescribe separate depreciation of components where assets comprise of various components with different useful lives, whose value is material in relation to the principal asset.

AASB 116 *Property, Plant and Equipment* states in relation to depreciation 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’. The standard also states ‘an entity allocates an amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciate separately each such part’. A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and depreciation method of another significant part of that same item. Such items may be grouped in determining the depreciation charge.

Failure to apply componentisation where appropriate may result in under or over‑stating the depreciation expense and the carrying amount of the reported asset.

Entities should consider the following principles when deliberating if a building should be regarded as comprising separate parts worthy of separate identification and depreciation. Judgment should be exercised by entity asset managers.

Where further guidance or assistance is required, the Valuer‑General Victoria (VGV) may be contacted for advice, assistance and consultation related to componentisation, in the context of valuation policy and determining asset useful lives.

# Scope

For external reporting requirements, componentisation is, by definition, confined to depreciable assets. This guidance is particularly applicable to depreciable assets of the nature of buildings but, where appropriate, could be applied to other non‑current physical assets. Componentisation is only recognised and relevant where it will have a material impact and is cost effective (refer to sections Materiality and Cost-benefit below).

# Identification and reliable measurement

Any component of an asset must lend itself to feasible *separate identification* within a complex or principal asset. Specialists (e.g. valuers, property managers, etc.) could provide advice on whether such asset parts are identifiable.

Some generic components of buildings can be identified irrespective of whether a building has a different purpose. (For example, a hospital, school and a prison, each includes generic components such as the external building structure or internal fixtures and fittings).

Some special purpose buildings have their own unique components beside the generic parts. (For example, ‘specialist mechanical services’ for a hospital and ‘monitoring and control systems’ for a prison could be a major element of the ‘trunk reticulated building systems’ component of the principal building.) Where components are separately identifiable, they should also be capable of being measured reliably. If a value cannot be directly attributable, apportionment of value may be appropriate.

# Useful lives

Componentisation is only required and relevant where the elements have materially different estimated useful lives.

Some assets have components that are renewed during the life of the principal asset, due to their shorter useful lives. The purpose of disaggregating an asset is to ensure that an entity’s depreciation policy allocates the depreciable amount of an asset on a systematic basis over its useful life and supports entity decision making.

When some components of the asset are componentised and depreciated separately, the remainder of that asset will have to be separately depreciated. If the individual costs of these remainder components are not significant, and the entity has varying expectations for these components, an approximation technique may be employed to depreciate the remainder of the asset in a manner consistent with its consumption/useful lives (AASB 116).

# Materiality

Where a component is separately identifiable and has an estimated useful life that is different from the principal asset, materiality should be considered.

Unless required for other management purposes, buildings should only be disaggregated into components where the different depreciation, resulting from useful lives of the components, will have a material impact on the entity’s financial results or position. The degree to which an entity applies componentisation will differ between entities depending on the entity’s size and nature.

Materiality for components and related depreciation is a matter of professional judgement and entities should refer to the views of subject matter specialists (asset managers/VGV).

Entities may wish to work out the difference in depreciation expense between applying and not applying componentisation for significant acquisitions to assist decision making as to whether it would materially impact on the entity’s financial statements. Any such working papers should be retained for subsequent reference.

# Cost‑benefit

When considering whether to undertake an asset dissection of buildings, entities may wish to also consider the costs in relation to the expected benefits of the undertaking. There could be instances where the merits or benefits of a dissection is outweighed by the costs and effort required to separately identify, track and keep records for components. In those cases, an approximation technique establishing an overall weighted average depreciation rate may be appropriate.

In summary, entities should apply their judgement using the high level principles articulated above, in totality. Judgement for thresholds for materiality and significance should be exercised by entities.

# Componentisation of depreciable assets – building example

Given that ‘buildings’ constitute a major asset class common to most entities, this Direction proposes a generic approach for building components (even if buildings are used for different specific purposes).

The components are –

**Structure/shell/building fabric** – includes the substructure, columns, floor, upper floors, staircases, roof, external walls, and windows.

**Site engineering services and central plant** – includes roads, footpaths, paved areas, boundary walls, fencing, gates, outbuildings, covered ways, landscaping improvements, external stormwater drainage, external sewer drainage, external water supply, external gas, external fire protection, external electricity, external communications and external special services.

**Fit out** – includes external doors, internal walls, ceilings, fitments, sanitary fixtures and special equipment. (Note: The fit out may be leased and so not owned by the reporting entity. In such circumstances, the fit out will not form a component of the building for depreciation purposes).

**Trunk reticulated building systems** – includes lifts, escalators, walkways, other (cranes, hoists etc.), centralised energy and other.

In addition to the above, there are some building elements common to two of the components above where it is not practical to differentiate, and they are treated as outlined below:

**Combined Fit Out and Trunk Reticulated Building Systems** – includes sanitary plumbing, water supply, gas, other fuel, electrical reticulated services, lighting, HVAC (mech. Environmental control) space heating, air‑conditioning, ventilation, evaporative cooling and other, fire protection, communications (telephone, computer links, monitoring systems, control systems and other), security.

The above dissection applies to hospitals, residential care buildings, government housing, schools and TAFE buildings, courts, police stations, correction centres, prisons, and government offices. Entities with specialised infrastructure assets may need to componentise accordingly.

# Recording, reporting and valuation

Entities will need to adopt and record, as part of the support for their accounting policies, their own guidelines as to the basis and materiality of any allocation of assets between components. Some identification is required to link the components to the principal asset. Where the cost of an asset has been allocated between components, the asset cost will need to be disaggregated in the asset register. Such component breakdown will not need to be disclosed in the notes to the balance sheet.

It is expected that the valuation method adopted for the components will be similar to the principal asset. This Direction prescribes fair value for buildings. Hence if an asset is valued at fair value, components of that asset should also be valued at fair value.

If any componentised asset is revalued, entities will need to establish procedures and guidelines as to how a change in valuation of the asset is apportioned. Where revaluation is performed by a valuer external to the entity, these procedures and guidelines, and the information to be supplied by the valuer, should be agreed in advance.