Accounting Treatment of Spare Parts - Capital Spares

Kabhi kisi 'EXTRA' ko 'extra' mat samajhna, kyunki kya pata us 'extra' ka accounting treatment 'EXTRA ordinary' ho.!!!

**SPARE PARTS:** 'Spare', as the name suggests, refers to additional or extra to what is required for ordinary use. That purely means an item kept as standby, in case another item of the same type is lost, broken, or worn out. These are purchased for the purpose of reducing the idle time of machineries and other auxiliary processes in case of sudden breakdowns or any other contingencies.

**For Example:** Machinery is purchased which is used in the production process and along with that, a back-up engine for the same is also purchased, to be used in circumstances of machinery breakdown. In this case back-up engine is treated as a 'Spare Part.'

**ACCOUNTING TREATMENT OF SPARE PARTS:**
Treatment of spare parts shall be done in accordance with the prevailing applicable provisions of Accounting Standards as prescribed from time to time. Spare Parts should be treated as per the definition and recognition criteria mentioned in Accounting Standard or Indian Accounting Standard. Now let's understand the treatment of spare parts under various aspects:

(A) Earlier Concepts: Spare Parts' treatment as per earlier approach was governed by two accounting standards namely, AS 2, 'Valuation of Inventories' and AS 10, 'Accounting for Fixed Assets' which are discussed below –

1. As per AS-2, Valuation of Inventories It was stated that 'Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular, such machinery spares are accounted for in accordance with AS-10, Accounting for Fixed Assets.

2. As per AS-10, Accounting for Fixed Assets: Machinery spares are usually charged to the Profit and Loss Statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset and their use is expected to be irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item.

(B) Revised Concepts: Ministry of Corporate Affairs, vide notification dated 30/03/2016 has amended the Accounting Standard 2, Valuation of Inventories, Accounting Standard 10 and Accounting Standard 6, now as 'Property, Plant & Equipment' applicable from the Financial Year 2016-17 on companies & from Financial Year 2017-18 for non-corporate assessees.
1. AS-2 Valuation of Inventories: It would not include those spare parts and stand by equipments under inventory that are considered as PPE as per Revised AS-10. As the same would be dealt as per AS-10. Other than those stated above, all other spare parts are classified under inventories.

2. Revised AS-10 Property, Plant & Equipment: Now, it has been specifically provided that, for any spare part to be covered under the scope of property, plant & equipment must satisfy the below mentioned definition criteria of PPE which states that:

- Assets which are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and,
- Assets which are expected to be used during more than a period of twelve months. On fulfillment of both the conditions an asset is considered as PPE.

**Recognition Criteria:** The cost of an item of property, plant and equipment should be recognized as an asset if, and only if:

- It is probable that future economic benefits associated with the item will flow to the enterprise; and
- The cost of the item can be measured reliably.
From the above mentioned conditions we can say that the revised accounting standard has become very specific regarding definition and recognition criteria. However, broadly the overall concept is similar to the criteria of previous Accounting Standard. Apart from that, some companies have to follow the provisions of Indian Accounting Standards, if applicable. Indian Accounting Standard 16, Property Plant & Equipment shall be taken into consideration for accounting treatment of spare parts. However, the treatment in Ind AS for accounting of spare parts is same as in Revised AS 10, as the revised AS-10 is drafted in accordance with the Ind AS 16 only.

Let's comprehend the above discussed concepts through some examples:

(A) Y Ltd. purchased a Gang saw machine for Rs.1,00,00,000 and extra cutting blades for Rs.5,00,000 for the machine which may be used whenever needed in other dissimilar cutting machines also. Useful life of the plant is 10 years and of the blades is 4 years.

As per old AS: The blades purchased can be used with other mounting/cutting machines also, though the use of blades is irregular, but still it would be treated as an item of inventory.

As per Revised AS: For the purpose of treatment an asset as PPE, the revised AS strictly provides for the definition criteria (discussed above). Herein, both the conditions provided are fulfilled as the purchased blades are for the purpose of production only and also its expected use is more than a period of 12 months. So as per Revised AS-10 it would be treated as a part of PPE and would be depreciated accordingly.

**Emphasis over Materiality Concept**

At times, we come across the dilemma regarding treatment of some assets that are used in the production process and also have life for more than 1 year, but its acquisition cost is very minute or you have a huge number of similar spare parts or servicing equipments. For example, small tools, moulds, pallets or containers are used for more than 1 year. In this case, these assets, however fulfill the definition criteria of PPE, but are to be treated as part of inventories, as it’s not practical keeping track of these assets and their accounting. Is it?
The judgment of the situation is very necessary as one should understand the generic
tention behind the law instead of going by the law BLINDLY. In such cases, we need to
assess materiality, or significance of spare parts. After learning the accounting treatments of
spares under PPE, now let's understand the depreciation accounting for spares purchased
in future and spares as at transition date. Any spares which are treated as assets as per
revised accounting standard 10, property plant & equipment shall be depreciated as per the
provisions contained under this standard only as the new standard merges AS-6
'Depreciation Accounting' with the PPE itself. Also the useful life of an asset may be shorter
than its economic life.

The estimation of the useful life of the asset is a matter of judgment based on the experience
of the enterprise with similar assets. As per AS-10, Property Plant & Equipment,
'Depreciation of an asset begins when it is available for use, i.e., when it is in the location and
condition necessary for it to be capable of operating in the manner intended by
management.'. Therefore, we can say that spare parts shall also be depreciated irrespective
of their actual usage because they are available for use whenever required.

For Example, B Ltd. Purchased a machine in addition to the main plant & machinery to be
used in business, then depreciation as per AS-10 shall also be applied on additional machine
since it is available for use whenever required. This is the major transformation from old AS,
since the spares which were considered as inventory till date would also be subject to
depreciation.

Now let us take a look over the Income Tax implications also. As the ultimate *GODFATHERS'*
are INCOME TAX AUTHORITIES, which are the decisive judges for outflow of money.

**Implications in Income Tax on application of provisions of Revised AS-10:**

Now, it is very imperative to ascertain the treatment of transitional provisions as well the
treatment of future purchases of such spare parts under Income Tax Act. The Income Tax Act
does not provide for any particular definition of capital asset or fixed asset. Moreover, there
is nothing mentioned about the recognition criteria of fixed asset or capital asset in section
43(1) which provides for the definition of 'cost of asset'.
As earlier also, before the introduction of Revised AS-10, the spares and other assets were capitalized under Income Tax either according to the particular provisions provided regarding the same under Income Tax Act or in absence of any specific provision, the same was accounted for in accordance with the accounting policies practiced by the entity. As decided in case of CIT, Delhi VS Woodward Governor India (P.) Ltd. (2009) 312 ITR 254 ‘in case of absence of any specific provision under the Income Tax Act 1961, the Hon'ble Supreme Court has adjudicated to abide by the accounting principles. In this case, it was held by the Supreme Court of India that profits for Income Tax purpose need to be computed as per ordinary principles of accounting and in line with the relevant Accounting Standards, unless such principles stand superseded or modified by legislative enactments.

Therefore, accounting method followed by assessee is presumed to be correct till Assessing Officer would come to the conclusion that the systems do not reflect true and correct picture of accounts. Thus the same treatment would be done under Income Tax also, until and unless any specific provision for capitalization of fixed asset is introduced.

I hope this article proves to be a smog remover vis-à-vis all the ambiguities regarding the book keeping and tax implications in ACCOUNTING OF SPARE PARTS.

Tags: Accounts

Recommended Read

- Transactions relating to Capital Goods under Goods and Services Tax
- Procedural Parts relating to TDS
income tax act so how could you say there is no specific provision of income tax on spare parts?

KARAN KHANCHANDANI

Hi Kartik! From above, I was explaining that nothing regarding the SPARE PARTS has been mentioned in the Income Tax Act for depreciation. So, first of all spare parts should be checked that whether they are in ambit of PPE, and then only section 32 of the Income Tax shall be applied on them.

NISHANT

nice article

KARAN KHANCHANDANI

Thanks!