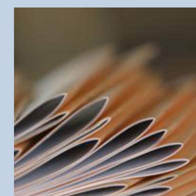
IFRS 1 – In a Canadian Context



Introduction and Background to IFRS 1

Generally on first time adoption of IFRS an entity is required to fully retrospectively apply all IFRS standards. For many entities adopting IFRS for the first time, having previously prepared financial statements in accordance with Canadian GAAP ('Canadian first time adopters'), to go back and restate all Canadian GAAP prepared accounting records since inception of the entity into IFRS accounting records would be an enormous task. Fortunately, the standard setters recognized this major impediment to adopting IFRS, not just to Canadian first time adaptors', but to all entities that adopt IFRS, and developed an accounting standard IFRS 1 - First Time Adoption of Financial Reporting Standards (IFRS 1), to provide relief to first time adopters.

The objective of IFRS 1 is to ensure that an entity's first IFRS financial statements, and the interim financial reports for part of the period they cover, contain high quality information that:

i) Is transparent for users and comparable over all periods presented;

ii) Provides a consistent starting point for accounting in accordance with International Financial Reporting Standards (IFRS); and

iii) Can be generated at a cost that does not exceed the benefits to users.

IFRS 1 provides some relief from the full retrospective application in the form of mandatory and optional exemptions. These are discussed in detail later on. Generally, they allow an entity to elect not to apply full retrospective application for certain standards. These exemptions are in areas where the International Accounting Standards Board (IASB) believes that the cost of complying with the requirements is likely to exceed the benefits to users of the financial statements.

Inside

Background to IFRS 1

When is IFRS 1 applied?

Key dates and need for comparatives

What is the opening IFRS 1 balance sheet?

What to disclose in the first annual financial statements?

What are the Exemptions from Full Retrospective Application?

What are the Optional Exemptions to Retrospective Application?

What are the Mandatory Exemptions to Retrospective Application?

IFRS 1 Future Developments

Conclusion

BDO Dunwoody LLP
Chartered Accountants
and Advisors

This is a publication of BDO Dunwoody LLP on developments in the area of Audit and Accounting. This material is general in nature and should not be relied upon to replace the requirement for specific professional advice. The information in this document is current as of June 30, 2008.

Along with this retrospective accounting issue there are other unique financial reporting issues that a first time adopter faces. For example, normally when an IFRS standard is adopted an entity is required to follow the transitional provisions included within each individual standard. These provisions were developed to apply to entities that already use IFRS so some of these provisions may not provide sufficient guidance to first time adopters' on what is required to adopt the standard. Therefore, generally IFRS 1 prohibits first time adopters from following these transitional provisions. First time adopters' must follow the provisions and requirements set out in IFRS 1. This may or may not require an entity to apply the transitional provisions of an individual standard, but generally this is not the case.

Another issue faced by first time adopters', is the amount of information they need to disclose in their first IFRS financial statements for users to fully understand changes that have been made from previous GAAP financial statements. IFRS 1 attempts to resolve this issue by prescribing what specific reconciliation disclosures are required, whether to follow an individual IFRS disclosure requirements and / or if other specific disclosures are required.

This document focuses on some of the issues that will impact a Canadian entity adopting IFRS for the first time. These issues include the key concepts and requirements of IFRS 1, when it is applied, what exemptions are available, the related implications for Canadian entities and future developments that have been proposed to IFRS 1 and are likely to become effective prior to Canada's changeover to IFRS. (For all of the examples referring to dates assume that the entity has a standard calendar year-end date and is not early adopting IFRS).

When is IFRS 1 Applied?

An entity's first IFRS financial statements are the first annual financial statements in which the entity adopts IFRS, with an explicit and unreserved statement in those financial statements of compliance with IFRS. The Canadian Accounting Standards Board (AcSB) has confirmed the change over date as being January 1, 2011. For Canadian entities with a calendar year-end the first annual financial statements adopting IFRS will be December 31, 2011. However, for many Canadian entities that adopt IFRS the first IFRS published financial information will be the first interim report, for the three months ended March 31, 2011.

Key Dates and the Need for Comparatives

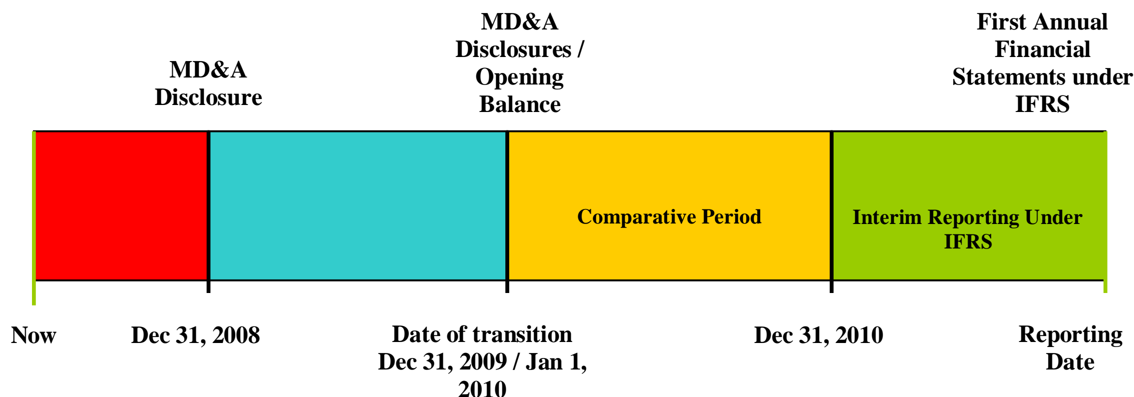
The first annual IFRS reporting date of December 31, 2011, which can be misleading for some as it still seems like a long time away.

To truly understand when an entity has to be ready for the adoption of IFRS, we need to look at IFRS 1. IFRS 1 defines the following dates:

> The transition date – *"the beginning of the earliest period for which an entity presents full comparative information under IFRS in its first IFRS financial statements."* So for a Canadian first time adopter with a calendar year-end their date of transition will be January 1, 2010.
>
> The reporting date – *"the end of the latest period covered by financial statements or by an interim financial report."* For an enterprise with a calendar year-end, the reporting date is December 31, 2011.

We believe an entity with a calendar year-end should be prepared for the adoption of IFRS by the transition date of January 1, 2010, which is two years earlier than the first annual reporting date. Since IFRS 1 also requires the comparative statements to be restated to comply with IFRS, entities need to be ready by the transition date. There are many recognition, measurement and disclosure differences between IFRS and Canadian GAAP, so the most efficient way to build the 2010 comparative statements is to maintain a set of Canadian GAAP and a set of IFRS statements in 2010.

© BDO Dunwoody LLP 2008



What is the Opening IFRS Balance Sheet?

An entity is required to prepare and present an opening IFRS balance sheet at the date of transition to IFRS in the entities first IFRS financial statements. This opening balance sheet is the starting point for the entity's accounting under IFRS.

In particular, IFRS 1 requires an entity to do the following in the opening IFRS balance sheet as a starting point for its accounting under IFRS:

i) Recognize all assets and liabilities whose recognition is required by IFRS;

ii) Not recognize items as assets or liabilities if IFRS do not permit such recognition;

iii) Reclassify items that it recognized under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under IFRS; and

iv) Apply IFRS in measuring all recognized assets and liabilities.

In preparing the opening balance sheet, an entity does not follow the standards that are in place at January 1, 2010, but rather the standards that will be in place at December 31, 2011. This creates a significant challenge, as first time adopters are not dealing with a stable platform. The IASB has many projects in place and standards will change between now and 2011. An entity needs to understand which standards are changing and / or likely to change between now and its first IFRS annual reporting date.

What to Disclose in the First Annual Financial Statements?

The first annual IFRS financial statements should be presented in accordance with the presentation and disclosure requirements of IAS 1 – Presentation of Financial Statements (IAS 1) and other relevant standards and interpretations. IFRS 1 does not provide an entity with relief from these presentation and disclosure requirements. To comply with IAS 1, an entity's first annual IFRS financial statements would have to include at least three statements of financial position (as at January 1, 2010, December 31, 2010 and December 31, 2011), two statements of comprehensive income, two separate income statements (if presented), two statements of cash flows and two statements of changes in equity (for the periods ended December 31, 2010 and December 31, 2011) and related notes, including comparative information prepared in accordance with IFRS[1]. Any historical summaries for periods before the first period for which they present full comparative information do not have to comply with the recognition and measurement requirements of IFRS. The entity should disclose that the information is not prepared in accordance with

[1] As per revised IAS 1: Presentation of Financial Statements. The revised standard is applicable for annual periods beginning on or after January 1, 2009. Earlier adoption is permitted.

IFRS, and include a narrative explanation of any major differences to IFRS. No quantitative disclosure is required for any differences.

IFRS 1 prescribes the detailed disclosures required to explain to users how the transition from previous GAAP to IFRS affected the entity's reported financial position, financial performance and cash flows. Any adjustments that arise are from events and transactions before the date of transition to IFRS. Except for any reclassifications from intangible assets to goodwill, the entity should recognize any adjustments directly in retained earnings (or, if appropriate, another category of equity) at the date of transition to IFRS (e.g. January 1, 2010).

A number of reconciliations between Canadian GAAP and IFRS are required in the first IFRS financial statements to illustrate to users the adjustments made. These include a reconciliation of:

i) The entities equity reported under previous GAAP to its equity under IFRS at the date of transition to IFRS. For a Canadian entity with a calendar year-end and adopting IFRS on January 1, 2011 this reconciliation would be as at January 1, 2010;

ii) The entities equity at the end of the latest period presented in the entity's most recent annual financial statements under previous GAAP. For a Canadian entity with a calendar year-end and adopting IFRS January on 1, 2011 this reconciliation would be as at December 31, 2010; and

iii) The profit or loss reported under previous GAAP for the latest period in the entity's most recent annual financial statements to its profit or loss under IFRS for the same period. For a Canadian entity with a calendar year-end and adopting IFRS on January 1, 2011 this reconciliation would be for the year-ended December 31, 2010.

The reconciliations need to provide sufficient detail to enable the user to understand the material adjustments to the balance sheet and income statement. An entity would also have to explain the material adjustments to the cash flow statement. An important disclosure requirement in relation to the reconciliations is that any corrections of errors made under previous GAAP identified during the conversion process should be separately distinguished from adjustments arising from changes in accounting policies.

What are the Exemptions from Full Retrospective Application?

IFRS 1 provides detailed guidance to first time adopters of IFRS with respect to applying individual standards. As mentioned above, generally an entity is required to apply IFRS standards retrospectively. However, IFRS 1:

i) Grants limited optional exemptions from these requirements in specified areas where the cost of complying with them would be likely to exceed the benefits to users of financial statements;

ii) Prohibits retrospective application of IFRS in some areas, particularly where retrospective application would require judgements by management about past conditions after the outcome of a particular transaction is already known; and

iii) Except in certain areas, prohibits an entity from applying the transitional provisions contained in each standard. The transitional provisions in IFRS typically apply to entities that have already adopted IFRS rather than first time adopters.

What are the Optional Exemptions to Retrospective Application?

As mentioned above IFRS 1 provides specific optional exemptions that an entity may elect to use when first adopting IFRS. An entity may take advantage of all, some or none of these exemptions but as the exemptions are specific an entity cannot apply any of these exemptions to other items. For example, an entity cannot apply the borrowing costs exemption to business combinations. Along with being specific the exemptions do not impact on the ongoing accounting policy choices that an entity can make under

IFRS. For example, if an entity elects to use fair value as deemed cost for property, plant and equipment it will not impact the IAS 16 accounting policy decision (i.e. adopting either the cost or revaluation measurement methods).

The optional exemptions available to a first time adopting entity are in the following areas:

i) Business combinations;

ii) Fair value or revaluation as deemed cost;

iii) Employee benefits;

iv) Cumulative translation differences;

v) Compound financial instruments;

vi) Assets and liabilities of subsidiaries, associates and joint ventures;

vii) Designation of previously recognized financial instruments;

viii) Share-based payment transactions;

ix) Insurance contracts;

x) Decommissioning liabilities included in the cost of property, plant and equipment;

xi) Leases;

xii) Fair value measurement of financial assets or financial liabilities at initial recognition;

xiii) A financial asset or an intangible asset accounted for in accordance with IFRIC 12 Service Concession Arrangements; and

xiv) Borrowing costs.

It is important for a Canadian entity to carefully review and make informed selections in relation to the exemptions. The level of work that is required in the conversion process for a specific area, such as business combinations, will be heavily influenced by the decision to elect to use or not use the optional exemptions that are available.

Business Combinations

For many Canadian entities that have completed acquisitions since inception electing to apply this exemption may save a lot of time, costs and resources. Under this exemption a first time adopter may account for transactions prior to the date of transition that meet IFRS 3 - Business Combinations (IFRS 3) definition, in three ways:

i) Retrospectively restate all business combinations since inception in accordance with IFRS 3;

ii) Elect to retrospectively restate all business combinations after a particular date in accordance with IFRS 3; or

iii) Elect not to retrospectively restate any business combinations (i.e. prospective application of IFRS 3).

This exemption is also available for past acquisitions of investments in Associates and interests in Joint Ventures and is very relevant for Canadian entities. A new business combinations standard has been proposed in Canada, which will be substantially converged with IFRS 3. The new standard will not be effective until the changeover, with early adoption permitted, and does not require retrospective application, which excluding the exemptions, IFRS 1 would require.

For many Canadian publicly accountable entities, retrospective application of IFRS 3 for past business combinations may be difficult, or even impossible, given the historical information currently available.

Therefore, some Canadian entities will only be able to elect to prospectively account for the past business combinations. The remaining entities need to consider whether they have the necessary information to apply IFRS 3 at the date of a business combination, or all subsequent business combinations, with sufficient reliability.

An entity that elects not to fully retrospectively adopt IFRS 3, but rather elects to restate all business combinations after a particular date, is also required to apply IAS 36 - Impairment of Assets (IAS 36) and IAS 38 – Intangible Assets (IAS 38) from that date, regardless of whether there is any indication of impairment[2]. For example, if a Canadian entity with a calendar year-end elects to restate a business combination that occurred on June 30, 2007, it shall restate all business combinations between June 30, 2007 and the date of transition to IFRS (January 1, 2010) and it shall also apply IAS 36 and IAS 38 from June 30, 2007.

Consequences of Not Applying Business Combinations Retroactively

In accordance with IFRS 1 the entity is required to recognize all assets acquired and liabilities assumed except for:

i) Some financial assets and liabilities derecognized under Canadian GAAP; and

ii) Items not recognized by Canadian GAAP that are also not recognized under IFRS.

If a first time adopter derecognized non-derivative financial assets or non-derivative financial liabilities under Canadian GAAP as a result of a business combination, the entity should not recognize those assets / liabilities under IFRS (unless they qualify for recognition as a result of a later transaction or event).

If an asset acquired, or liability assumed, in a past business combination was not recognized under Canadian GAAP, it does not have a deemed cost of zero in the opening IFRS balance sheet. Instead, the acquirer recognizes and measures the asset or liability in its consolidated balance sheet on the basis that IFRS would require in the balance sheet of the acquiree. For example, if under Canadian GAAP the acquirer had not, capitalized finance leases (capital leases under Canadian GAAP) acquired in a past business combination, the entity should capitalize those leases in its consolidated financial statements, as IAS 17 - Leases would require the acquiree to do in its IFRS balance sheet. Conversely, if an asset or liability was included in goodwill under Canadian GAAP accounting but would have been recognized separately if IFRS 3 was applied at the time of the business combination, that asset or liability remains in goodwill unless IFRS would require its recognition in the financial statements of the acquiree.

An entity's opening balance sheet must also exclude any previously recognized items that do not meet IFRS recognition criteria. For example, a first time adopter may have, in a past business combination recognized as an intangible asset an item that does not qualify for recognition under IAS 38. Where this is the case, the entity should reclassify the intangible items to goodwill. All other changes (i.e. not intangible asset related) with respect to acquired or assumed items are recognized in retained earnings. Therefore, in the previous example the entity should reclassify that intangible item under Canadian GAAP (and any related future tax and minority interest) as part of goodwill.

Other significant consequences of not applying IFRS 3 retrospectively are:

i) The entity would retain the Canadian GAAP classifications, such as legal acquirer or legal acquiree, uniting of interests;

ii) The carrying amount of goodwill recognized under Canadian GAAP is not adjusted, except for specific circumstances as set out above or resolution of contingent purchase consideration before the date of transition; and

[2] This requirement is amended to be in accordance with IAS 27 – Consolidated and Separate Financial Statements (revised 2008). The revised standard is applicable for annual periods beginning on or after July 1, 2009. Earlier adoption is permitted.

iii) There is no requirement to remeasure some assets and liabilities original values at the time of the business combination to fair value after initial recognition.

In addition to ii) above, for a Canadian entity, the Canadian GAAP purchase allocation of items will be used as the IFRS 'deemed acquisition cost'. This is an important concept as this deemed cost is the basis for measurement of those assets and liabilities. The deemed cost is the basis for cost based depreciation or amortization from the date of the business combination, rather than the date of transition to IFRS.

Relating to point iii) above, some standards require an entity to remeasure to fair value some assets and liabilities after initial recognition. Where a first time adopting entity elects not to apply IFRS 3 retrospectively, the item should be remeasured to fair value at the date of transition, with any differences being recognized as a change in retained earnings. The change is not reflected in goodwill.

Another issue that may arise is in relation to consolidation of subsidiaries. It is possible that a first-time adopting Canadian parent entity may not have consolidated an entity that the parent is required to consolidate under IFRS. This is because the requirements to consolidate under IFRS are based on control and this control test is different from Canadian GAAP consolidation requirements. Therefore, due to differences in approach the parent may not have regarded the entity as a subsidiary or consolidated the entity under Canadian GAAP, whereas the entity is a subsidiary under IFRS. Under Canadian GAAP no consolidation was performed, but under IFRS consolidation is required. Therefore the entity is required to recognize the subsidiary's assets and / or liabilities at the level IFRS would require in the subsidiary's separate balance sheet. In this case, goodwill is to be determined for this entity at the date of transition. The deemed cost of goodwill in this instance is the difference between i) the parents interest in the subsidiary's equity, as adjusted under IFRS at the date of transition, and ii) the parents cost of the investment in the subsidiary at the acquisition date.

Fair Value or Revaluation as Deemed Cost

With respect to property, plant and equipment a first time adopting entity may make three elections on transition to IFRS. These elections relate to:

i) Deemed cost;

ii) Changes in existing decommissioning, restoration and similar liabilities included in the cost of property, plant and equipment (see exemption section below); and

iii) Borrowing costs (see Borrowing Costs exemption section below).

A first-time adopter may elect to use one of the following as deemed cost of an item of property, plant and equipment:

i) Fair value at the date of transition;

ii) A revaluation under previous GAAP that is broadly comparable to fair value or cost or depreciated costs under IFRS, adjusted to reflect, for example, changes in a general or specific price index; or

iii) A previous GAAP event-driven fair value measurement (e.g. Initial Public Offering).

An entity may want to use one of these elections for reasons such as:

i) Differences between the cost recorded under Canadian GAAP and what would be recorded as cost in accordance with IFRS. To determine this may take up a lot of resources that could be used elsewhere in the conversion process;

ii) Difficulty retrospectively applying IFRS component accounting as historical information may no longer be available; or

iii) The entity simply wants to use the exemption.

In relation to the exemption, fair value at the date of transition is usually the items appraised market value at that same date. This value should be the highest possible price that could be obtained by the entity for the item, without reference to the items current use in the entity. Furthermore, no deduction should be made in determining market value for any estimated disposal costs.

If an entity is unable to determine the market value, due to i) the specialized nature of the property, plant and equipment and/or ii) the item is rarely sold, the entity will need to estimate the market value based on an income or depreciated replacement cost approach.

It is unlikely an entity that has previously complied with Canadian GAAP would have made a revaluation in accordance with point ii) above. However, in accordance with Canadian GAAP, Section 3061.44 or Section 1625 of the Handbook, an entity may have made an event driven revaluation as per point iii) above.

The ability to use previous revaluations as deemed cost may result in Canadian entities that applied push down accounting in the past, although the concept of push down accounting doesn't exist under IFRS, to use those push down accounting values as deemed cost.

If a revaluation under previous GAAP did not satisfy ii) or iii) above, an entity measures the revalued assets in its opening balance sheet on one of the following bases:

i) Cost less any accumulated depreciation and any accumulated impairment losses under the cost model in IAS 16 – property, plant and equipment (IAS 16);

ii) Deemed cost, being the fair value at the date of transition to IFRS; or

iii) Revalued amount, (if adopting the revaluation model in IAS 16).

An entity may also use the above fair value or a revalued amount as deemed cost for items of Investment Property, if the entity elects to use the cost model in IAS 40 – Investment Property, and / or IAS 38, provided the recognition and revaluation criteria in IAS 38 are satisfied, and fair value can be determined by reference to an active market.

If the entity elects to use deemed cost, depreciation is based on that deemed cost and starts from the date from which the entity established the fair value measurement or revaluation. Further, where the entity's depreciation methods and rates under previous Canadian GAAP are acceptable under IFRS, any change in estimated useful life or depreciation are accounted for prospectively from the date the change is made. Where this is not the case and the differences result in a material effect on the financial statements, the entity must make a retrospective adjustment so that accumulated depreciation in its opening IFRS balance sheet complies with IFRS.

Electing to use fair value as deemed cost may have implications on other areas of the financial statements for an entity. For example, where the fair value amount exceeds or increases the carrying value of property, plant and equipment, the subsequent future depreciation expense is likely to be greater than what it would have been without the fair value adjustment. As the fair value amount is higher, it is also more likely that impairment losses may need to be recognized in future periods.

Cost or Revaluation Measurement Method

Another important consideration when adopting IFRS is that an entity must make an accounting policy choice whether to use the revaluation or cost method of accounting for each class of property, plant and equipment. For more information on the accounting policy choice see Issue 3 of our IFRS – Canadian GAAP Differences Series – property, plant and equipment.

If an entity chooses the revaluation method for some or all classes of property, plant and equipment, the cumulative revaluation surplus should be presented as a separate component of equity. The revaluation surplus at the date of transition to IFRS is based on a comparison of the carrying amount of the asset at that date with its cost or deemed cost. If the deemed cost is the fair value at the date of transition, the

entity's first IFRS financial statements for each line item must include disclosures of the aggregate of the fair values and the aggregate adjustment to the previous Canadian GAAP carrying amounts.

Employee Benefits

Under IAS 19 - Employee Benefits, an entity may elect to use a 'corridor' approach that leaves some actuarial gains and losses unrecognized. This is similar to the approach in current Canadian GAAP Section 3461 - Employee Future Benefits. Therefore, the exemption may not have as substantive an impact as those already mentioned.

Retrospective application of the corridor approach would require an entity to split the cumulative actuarial gains and losses from the inception of the plan until the date of transition to IFRS into recognized and unrecognized portions. However, under IFRS 1 a first-time adopter may elect to recognize all cumulative actuarial gains and losses at the date of transition to IFRS. If a first-time adopter uses this election, they shall apply the election to all defined benefit plans. However, this election can be used even if the entity uses the corridor approach for subsequent actuarial gains and losses. This allows some Canadian entities currently using the corridor approach to elect to use this exemption. For example, an entity may have unrecognized actuarial losses. By using the exemption the entity will recognize these cumulative actuarial losses, in the form of a charge to total equity at the date of transition and will thereby potentially reduce the future pension expense or amortization. Only actuarial losses arising subsequent to the date of transition will be amortized and recognized in the profit and loss.

IFRS 1 also provides an optional exemption with respect to IAS 19 disclosures. Amongst the prescribed disclosures of IAS 19, an entity is required to disclose for the current and four previous annual periods the present value of the defined benefit obligation, the fair value of the plan assets and the surplus or deficit in the plan; and experience adjustments arising on the plan liabilities expressed either as (i) an amount or (ii) a percentage of the plan liabilities at the balance sheet date and the plan assets expressed either as (i) an amount or (ii) a percentage of the plan assets at the balance sheet date. The IFRS 1 exemption allows a first time adopter to disclose these amounts as the amounts are determined for each accounting period prospectively from the date of transition to IFRSs.

Cumulative Translation Differences

Under IAS 21 – The Effects of Changes in Foreign Exchange Rates, translations of foreign operations are performed using the current method. This is the same method as Canadian GAAP uses to translate self-sustaining operations. This method results in exchange differences being recognized as a separate component of equity. The accumulated translation differences are recognized in profit and loss, as part of the gain or loss on disposal of the subsidiary only on disposal of the related foreign operation.

The exemption in IFRS 1 allows a first time adopter to elect not to calculate this translation difference retrospectively. Where this election is made the cumulative translation balance for all foreign operations is set to zero, at the date of transition. The gain or loss on subsequent disposal of a foreign operation will therefore only include foreign exchange differences arising subsequent to the date of transition.

This election could be beneficial to entities that want to 'tidy' up the cumulative translation balance by setting it to zero. In addition it will allow entities to avoid the adjustments to the balance which would be required as a result of the IFRS transition adjustments of foreign operations.

Compound Financial Instruments

On first time adoption of IFRS an entity is required to retrospectively apply IAS 32 - Financial Instruments Disclosure and Presentation (IAS 32). Where a compound instrument is issued, IAS 32 requires the instrument be split into its two component parts (debt and equity). This classification of the components is based on the conditions that existed at the date the instrument first met the recognition requirements of IAS 32. Therefore, applying IAS 32 retrospectively the carrying amounts would need to be determined on the basis of circumstances existing when the instrument was issued, not on circumstances at the date of transition.

However, under IFRS 1, if the liability component of the instrument has either been settled or converted prior to the date of transition, an entity can elect not to split the amount recognized into the debt and equity components. The reason for this exemption is that retrospective adjustment would only result in an analysis of the amounts in shareholders' funds into two separate components. Therefore, this exemption allows an entity to avoid the reallocation of equity components. An entity must remember that this exemption only covers situations where the liability component is no longer outstanding. If the liability is still outstanding this difference will have to be adjusted for on transition to IFRS.

This exemption may not seem that relevant to entities reporting in accordance with Canadian GAAP as they are currently required to make a split into debt and equity. However, when comparing Canadian GAAP and IFRS, a difference in relation to how the split between debt and equity is allocated. Broadly under Canadian GAAP there are two methods of allocating the proceeds either i) the relative fair value method, the fair value of each component is determined and allocate the proceeds on a prorata basis, or ii) the residual method where an entity determines the fair value of the component, which is easier to determine and allocates the residual proceeds to the other component. Under IFRS the liability component is always calculated first and the equity component is allocated the residual amount. This difference in allocation may impact whether or not an entity will elect to use the exemption.

Assets and Liabilities of Subsidiaries, Associates and Joint Ventures

This is an important exemption for many Canadian entities with foreign parents that have either already adopted IFRS or will not be adopting IFRS at the same date as the Canadian entity. For example, when a Canadian subsidiary adopts IFRS in Canada it may have a different date of transition to that of the parent entity. For example, if the parent is a European company its date of transition may have been January 1, 2004, while the Canadian entities date of transition may be January 1, 2010. Therefore, potential differences between the parent and subsidiary accounting records could exist, especially where the measurement is dependent on the date of transition to IFRS, or in relation to IFRS 1 elections. This goes against one of the objectives of using IFRS - to ease the financial reporting burden for groups with operations in multiple jurisdictions.

Therefore, IFRS 1 provides an optional exemption for a subsidiary that is a first-time adopter later than its parent entity. This optional exemption is also available for Associates and Joint Ventures.

In this scenario IFRS 1 allows a subsidiary to measure its assets and liabilities at either:

i) The carrying amounts included in the parent's consolidated financial statements, based on the parent's date of transition to IFRS, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary; or

ii) The carrying amounts required by IFRS 1, based on the subsidiary's date of transition to IFRS.

If the entity elects to use option i) above, the subsidiary and parent will avoid recognizing different amounts (other than for consolidation adjustments) in their financial statements.

IFRS 1 also provides guidance in situations where:

i) A parent is a first-time adopter later than its subsidiary; or

ii) A parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements.

In relation to the first scenario, where the entity becomes a first-time adopter later than its subsidiary (or associate or joint venture), the parent in its consolidated financial statements should measure the assets and liabilities of the subsidiary (or associate or joint venture) at the same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidiary.

In relation to the second scenario, where a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, the parent entity should measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments.

Designation of Previously Recognized Financial Instruments;

This exemption relates to the classification of financial instruments at the date of transition to IFRS. Classification of financial instruments is an issue that Canadian entities have encountered with the recent adoption of Section 3855 - Financial Instruments – Recognition and Measurement of the CICA Handbook (Section 3855). While similar Section 3855 and IAS 39 - Financial Instruments: Recognition and Measurement (IAS 39) do have some differences, especially with respect to designating financial instruments at fair value through profit and loss, or what is termed as held for trading under Section 3855.

Due to the differences this exemption may still be applicable to Canadian entities that have adopted Section 3855.

The IFRS 1 exemption permits a first time adopter at the date of transition to make an available for sale designation, or to designate any financial asset or financial liability as at fair value through profit and loss provided the asset or liability meets IAS 39 criteria. Therefore, a Canadian entity may elect to use the exemption to designate a held for trading financial instrument as available for sale at the date of transition.

Share-based Payment Transactions

IFRS 2 - Share Based Payments (IFRS 2) applies to situations where an entity grants shares or share options to employees or to other parties providing goods and services and requires these payments to be recognized as an expense in the entity's financial statements.

Generally, a first time adopter should apply IFRS 2 retrospectively. However, while a first time adopter is encouraged to retrospectively apply IFRS 2, an entity may elect not to retrospectively apply IFRS 2 to equity instruments (equity settled transactions) granted on or before November 7, 2002.

Similarly, while IFRS 1 encourages a first time adopter to apply IFRS 2 to equity instruments that were granted after November 7, 2002 and that vested before the later of i) the date of transition and ii) January 1, 2005 (for Canadian entities the later date will be the date of transition, January 1, 2010), an entity may elect not to retrospectively apply IFRS 2 to these equity instruments. However, an entity can only retrospectively apply IFRS 2, if it had previously disclosed publicly the fair value of those equity instruments, determined at the measurement date. This may be an issue for Canadian entities as the requirements under IFRS and Canadian GAAP in relation to options with graded vesting are different. Therefore, retrospective application of IFRS 2 may not be possible and those entities may be forced to make this election.

Unfortunately for Canadian entities, November 7, 2002 is earlier than the transitional date of January 1, 2004 that was used for employee stock options when Section 3870 – Stock Based Compensation and Other Stock Based Payments (Section 3870) was introduced. Under transitional provisions of Section 3870, an entity had the option to choose to retrospectively or prospectively apply Section 3870. If a Canadian entity elected to use the prospective application from January 1, 2004 the entity will need to make this election, unless the entity wants to now retrospectively apply IFRS 2 to employee stock options.

If a first time adopter elects to apply the exemption, it is nevertheless required to disclose information that enables users of the financial statements to understand the nature and extent of share based payment arrangements that existed during the reporting and comparative period.

In addition to the exemptions relating to equity instruments, an entity is encouraged but not required to retrospectively apply IFRS 2 to liabilities arising from share based payment transactions (cash settled transactions) that were settled before the date of transition or prior to January 1, 2005. An entity can

elect not to retrospectively apply IFRS 2 to share based payments of this type that were not settled before the date of transition or prior to January 1, 2005. The treatment of these types of liabilities is significantly different under IFRS than that required under current Canadian GAAP. These differences may result in many Canadian entities having to elect to use the exemptions available.

Insurance Contracts

In contrast to the IFRS 1 general principle of not allowing a first time adopter to apply a specific standards transitional provisions, an entity issuing insurance contracts (insurer) may elect on first time adoption to apply the transitional provisions of IFRS 4 – Insurance Contracts (IFRS 4). These provisions allow an insurer to apply IFRS 4 prospectively for reporting periods beginning on or after January 1, 2005. However, generally IFRS 4 restricts changes in accounting policies for insurance contracts. Therefore, this effectively means that Canadian entities will continue to account for insurance contracts as they have under Canadian GAAP.

Decommissioning Liabilities Included in the Cost of Property, Plant and Equipment

Under IFRIC 1 – Changes in Existing Decommissioning, Restoration and Similar Liabilities, any changes in the estimated value of an existing decommissioning, restoration or similar liability, which under Canadian GAAP are typically referred to as Asset Retirement Obligations (ARO), shall be added to, or deducted from, the cost of the asset to which it relates. Without an exemption, this change would require an entity to retrospectively recalculate the decommissioning liability and the related impact on the cost of the related asset and accumulated depreciation.

For a first time adopter, retrospective application of these requirements would require an entity to construct historical records of all such adjustments that would have been made in the past, which in many cases would be impractical. Therefore, IFRS 1 provides an optional exemption for an entity to elect not to comply with these requirements, for such liabilities incurred before the date of transition to IFRS. If using this exemption a first time adopter is required to:

i) Measure the liability (or ARO) at the date of transition to IFRS in accordance with IAS 37 - Provisions, Contingent Liabilities and Contingent Assets;

ii) Estimate the amount that would have been included in the cost of the related asset when the liability first arose, by discounting the liability to that date using the best estimate of the historical risk adjusted discount rates that would have applied for that liability over the intervening period; and

iii) Calculate the accumulated depreciation on that amount as at the date of transition to IFRS, on the basis of the current estimate of the useful life of the asset, using the depreciation policy adopted by the entity under IFRS.

The effects of any changes from previous GAAP, as a result of this, are recognized in the opening IFRS balance sheet in net assets and retaining earnings.

Although entities have been accounting for ARO's under Canadian GAAP, there is a difference between Canadian GAAP and IFRS with respect to the obligations that are included. Canadian GAAP is based on legal obligations whereas IFRS also includes constructive obligations. Therefore, on adopting IFRS an entity may exist as to when and how changes in estimates are accounted for.

The effect of electing to use this exemption is that an entity does not have to attempt to determine when and how the changes in estimates arose. Instead, the entity will recalculate the liability as at the date of transition and then adjust this amount for a historical risk discount rate, to estimate the amount when the liability arose. This balance is then added to the cost of the asset and accumulated depreciation adjusted accordingly.

© BDO Dunwoody LLP 2008

Leases

At the date of transition to IFRS, a lessee or lessor classifies leases as operating leases or finance leases as determined under IFRS, rather than the operating and capital lease categorization under Canadian GAAP, on the basis of circumstances existing at the date of inception of the lease.

IFRS 1 allows a first time adopter of IFRS to apply the transitional provisions of IFRIC 4 - Determining whether an Arrangement contains a Lease (IFRIC 4). This is an interpretation that takes a substance over form approach to identifying whether a transaction or arrangement contains a lease. IFRIC 4 looks at whether a transaction or a series of related transactions, that may not take the form of a legal lease, but convey a right to use an asset in return for a payment or series of payments is a lease. The interpretation is very similar to EIC 150 – Determining Whether an Arrangement Contains a Lease. Due to this, even if a Canadian entity elects to use the exemption the entity would have to assess arrangements that they have already assessed under EIC 150. Many observers believe that this, reassessing items that have already been assessed under identical requirements of an entities previous GAAP, is an ineffective use of resources during the conversion process, As such a proposed change to IFRS 1 has been made. (See IFRS 1 Future Developments section later in this publication for more details on this).

Fair Value Measurement of Financial Assets or Financial Liabilities at Initial Recognition

This is an exemption included in IFRS 1 that is not applicable for Canadian entities as it requires prospective application from January 1, 2004. The exemption allows an entity to elect to apply the last sentence of IAS 39 paragraph AG76, and paragraph AG76A in relation to recording day one gains or losses, or gains and losses due to the transaction price not equaling the fair value amount of a financial asset or liability prospectively.

IFRIC 12 - Service Concession Arrangements

Like the insurance contracts exemption above, IFRS 1 allows a first-time adopter to elect to apply the transitional provisions in IFRIC 12. The IFRIC 12 transitional provisions provide special relief when retrospective application is impracticable. Guidance on what is deemed to be impracticable is provided in IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors. This test used in IFRS appears to be a more stringent test of impracticality than is applied in Section 1506 – Accounting Changes of Canadian GAAP.

If retrospective application at the date of transition is impracticable, then an operator should:

i) Reclassify assets recognized previously under the service concession arrangement as intangible and / or financial assets at the date of transition, without remeasurement from the previous recognized carrying amount of the assets; and

ii) Test the financial and intangible assets recognized for impairment at the date of transition, or if this is impracticable, at the start of the current period.

Borrowing Costs

Again, similar to the insurance contracts and service concession exemptions above, a first-time adopter may elect to apply the transitional provisions of IAS 23 - Borrowing Cost (revised 2007) (IAS 23). The IAS 23 transitional provisions allow an entity to choose the date to apply capitalization of borrowing costs relating to all qualifying assets. This date is either:

i) The later of January 1, 2009 or the date of transition to IFRS; or

ii) An earlier date.

Where an entity does not elect to use deemed cost for property, plant and equipment and elects to apply capitalization of borrowing costs from a date prior to the date of transition to IFRS, the capitalization of

borrowing costs in the cost of property, plant and equipment should be in accordance with IAS 23. This may require a change in the actual cost of the property, plant and equipment from that recorded previously under Canadian GAAP.

What are the Mandatory Exemptions to Retrospective Application?

IFRS 1 prescribes four mandatory exemptions which prohibit an entity from applying standards retrospectively. In these situations IFRS 1 requires an entity to make a prospective application of the relevant standard. The four mandatory exemptions are:

i) Derecognition of financial assets and financial liabilities;

ii) Hedge accounting;

iii) Estimates; and

iv) Assets classified as held for sale and discontinued operations.

Derecognition of Financial Assets and Financial Liabilities

Financial assets and financial liabilities are required to be recognized and measured in the opening IFRS balance sheet in accordance with IAS 39. As an exemption in IFRS 1, if the entity has achieved derecognition of the financial assets and / or financial liabilities under Canadian GAAP before January 1, 2004, these are not required to be recognized again in the opening balance sheet. For example, if an entity entered into a securitization agreement on December 30, 2003 and determined that the derecognition criteria of AcG-12 - Transfers of Receivables (i.e. can be treated as a sale) was achieved, the entity does not have to consider whether or not the derecognition criteria of IAS 39 is met at the date of transition to IFRS. The entity will continue to leave this off the balance sheet. However, if the same entity entered into a securitization transaction on January 2, 2004 it would have to consider the recognition and measurement requirements of IAS 39, if the assets derecognized still exist at the date of transition.

However, IFRS 1 also allows a first time adopter to elect to retrospectively apply the derecognition requirements in IAS 39 from an earlier date than January 1, 2004, provided the information required to do so was obtained at the time of initially accounting for the transaction.

Hedge Accounting

A first time adopter is required to apply IAS 39, at the date of transition to IFRS. Therefore an entity is required to:

i) Measure all derivatives at fair value; and

ii) Eliminate all deferred losses and gains arising on derivatives that were reported under previous GAAP as if they were assets or liabilities.

As a result, the opening IFRS balance sheet of a first time adopter should not include a hedging relationship of a type that does not qualify for hedge accounting under IAS 39. A hedging relationship only qualifies for hedge accounting under IAS 39 if a number of specific restrictive criteria are met, including designation and detailed documentation of the effectiveness of the hedge, both at inception and subsequently. Designation of a hedging relationship cannot be made retrospectively, therefore, if an item was not designated as a hedge under Canadian GAAP then that item can not be designated a hedge under IFRS. However, if an entity designated a net position as a hedged item under previous GAAP, it may designate an individual item within that net position as a hedged item under IFRS.

Hedge accounting in accordance with IAS 39 is similar to hedge accounting under Canadian GAAP (i.e. Section 3865). However, certain differences exist between the two standards which may result in some Canadian hedges not being accounted for as hedges under IFRS. For example, Canadian GAAP allows the use of a short cut method, whereas this is not permitted in IFRS. In these cases, where a previously

designated hedge item under Canadian GAAP does not meet the full detailed criteria for hedge accounting under IAS 39, the entity would have to reverse the hedge accounting on adoption.

Estimates

When restating the opening IFRS balance sheet an entity may have information available that was not available at the time an accounting estimate was originally made. This exemption is to prevent an entity from adjusting previously made accounting estimates for the benefit of hindsight. IFRS 1 requires that all accounting estimates at the date of transition to IFRS should be made consistently with the accounting estimate made under previous GAAP, unless:

i) There is a difference in accounting policies; or

ii) There is objective evidence that they were in error.

Where an entity is required to make an accounting estimate on transition to IFRS that was not required under previous GAAP, those estimates should reflect conditions that existed at the date of transition. For example, estimates of market based prices should reflect the market conditions at the date of transition and not reflect events that occurred after that date.

To help illustrate this issue, take an entity that prepared its December 2009 financial statements in accordance with Canadian GAAP. Those financial statements included a provision for asset impairment due to market conditions. Suppose that in 2011, the market circumstances changed such that the impairment amount would be different taking into consideration the new additional information. When preparing the opening IFRS balance sheet at January 1, 2010 the provision would not reflect the new information which became available in 2011.

Assets Classified as Held for Sale and Discontinued Operations

This was an exemption that was applicable for entities adopting IFRS in 2005. Any entities adopting IFRS after January 1, 2005, such as Canadian first time adopters are now required to retrospectively apply IFRS 5 - Non-current Assets Held for Sale and Discontinued Operations. This effectively requires an entity to reverse depreciation on non-current assets classified as held for sale, from the date those assets satisfied the held for sale criteria.

IFRS 1 Future Developments

The staff of the Canadian Accounting Standards Board (AcSB) have presented to the IASB proposed amendments to IFRS 1 to address challenges that Canadian entities, and others around the world, are likely to face on first time adoption of IFRS. Set out below is a summary of the issues and initial draft wording for the proposed amendments to IFRS 1[3]:

i) Retrospective restatement of fair values - To introduce a principle prohibiting retrospective estimates that could be affected by hindsight.

   The AcSB's proposed wording is *"This IFRS prohibits a first-time adopter from retrospectively determining fair values as of dates prior to the date of transition to IFRSs when those fair values were not available when IFRSs required them to be determined. When a fair value was not available, an entity shall use in its place the carrying amount at that date under its previous GAAP".*

ii) Reassessment of accounting under previous GAAP - To introduce a principle that an entity need not reassess the accounting for a transaction at the date of transition to IFRS on the basis of facts and circumstances at that date, if the entity's previous GAAP had introduced the same accounting treatment as IFRS based on an assessment of facts and circumstances

[3] International Accounting Standards Board Meeting May 2008

at an earlier date. For example, suppose that an entity's previous GAAP had from periods beginning on January 1, 2007 incorporated the same requirements as IFRIC 4 - Determining whether an Arrangement contains a Lease, with a transitional requirement to assess contracts existing at that date. If the entity's date of transition to IFRS is January 1, 2010, the entity would not need to reassess at January 1, 2010 those leases that it had already been assessed under its previous GAAP.

The AcSB's proposed wording is *"This IFRS permits a first-time adopter not to reassess the accounting for a past transaction at the date of transition to IFRSs, based on facts and circumstances at that date, when previous GAAP had introduced the same accounting as IFRSs based on an assessment of facts and circumstances at an earlier date. A first-time adopter electing not to reassess its previous accounting in such circumstances shall continue to use the assessment made in accordance with the previous GAAP".*

iii) Full cost accounting for the oil and gas industry - To permit an entity using full cost accounting for oil and gas to measure exploration, evaluation, development and production assets on transition to IFRS on the basis of an allocation of the amount recognized under the entity's previous GAAP. The Board acknowledged that either retrospective restatement of oil and gas assets or their measurement at fair value at the transition date, as currently permitted by IFRS 1, might not be cost beneficial.

The AcSB staff suggested adding the following paragraphs to IFRS 1:

"The exemption:

19A An entity may elect to measure oil and gas assets at the date of transition to IFRSs on the following basis: (a) exploration and evaluation assets at cost, less any impairment, determined in accordance with IFRS 6, Exploration for and Evaluation of Mineral Resources; and (b) other assets (i.e. those in the development or production phases) at the amount determined under the entity's previous GAAP, first adjusted by the difference between the decommissioning, restoration or similar liability as measured in accordance with IAS 37 and that recognized under the entity's previous GAAP. The adjusted amount is then allocated on a pro rata basis using reserve volumes or related values as of that date. An entity making this election does not apply paragraph 25E for these assets.

The deemed cost for each oil and gas asset determined as above shall be tested for impairment at the date of transition to IFRSs. For purposes of this paragraph, oil and gas assets comprise only those used in the exploration, evaluation, development or production of oil and gas.

Disclosure requirements:

44A. Paragraph 19A provides an exemption for oil and gas assets. If an entity uses that exemption, it shall disclose that fact and the basis on which carrying amounts under previous GAAP were allocated."

The IASB has requested the staff of the AcSB prepare, on behalf of the IASB Board, an IFRS 1 exposure draft, with a comment period of 180 days, to gain all IFRS user views on the proposed amendments. No IASB Board members indicated that they would dissent on the proposed changes. This exposure draft is expected later in 2008.

Also at the May 2008 IASB meeting, the AcSB highlighted to the IASB Board that some Canadian rate-regulated entities have capitalized amounts into property, plant and equipment that would not be permitted to be capitalized in accordance with IFRS. Due to the capital intensive nature of this industry, age of the items and the difficulty in obtaining a fair value amount, to apply IFRS retrospectively or to use the fair value as deemed cost in accordance with IFRS 1, is not practical. Therefore, the AcSB proposed that IFRS 1 is amended to include an exemption permitting all first-time adopters to elect to use the IFRS transition date carrying amount of an item of PP&E (containing previously capitalized amounts not in compliance with IFRSs) as deemed cost at that date. Under this proposal, entities applying the exemption would be required to undertake impairment testing at the transition date. The IASB Board agreed to proceed with the proposal subject to the exemption being available for rate regulated entities only.

Conclusion

In summary, the basic approach to IFRS 1 for an entity is to:

i) Identify the first IFRS annual financial statements (e.g. December 31, 2011);

ii) Prepare an opening balance sheet at the date of transition to IFRS (e.g. January 1, 2010);

iii) Identify the standards that are effective for the entity's first IFRS annual financial statements (e.g. December 31, 2011);

iv) Select accounting policies based on those standards;

v) Apply those policies fully retrospectively in preparing the opening balance sheet (for example, January 1, 2010);

vi) Consider whether to apply any optional exemptions from retrospective application;

vii) Apply the mandatory exemptions from retrospective application; and

viii) Make extensive disclosures to explain the transition to IFRS.

If you require further guidance on first time adoption of IFRS, IFRS 1 or any other IFRS information or reference sources, please contact your local BDO Dunwoody LLP office or visit www.bdo.ca/ifrs.

BDO Dunwoody LLP is a Member Firm of BDO International. BDO International is a world wide network of public accounting firms, called BDO Member Firms, serving international clients. Each BDO Member Firm is an independent legal entity in its own country.