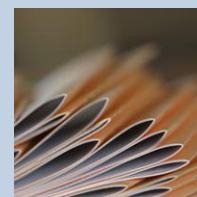


Canadian GAAP – IFRS

Comparison Series

Issue 3 – Property, Plant and Equipment



Both IFRS and Canadian GAAP are principle based frameworks and from a conceptual standpoint many of the general principles are the same. However, the application of those general principles in IFRS can be significantly different from Canadian GAAP. Therefore, to understand the magnitude of the differences between IFRS and Canadian GAAP, it is essential to look beyond the general principles and look at the detailed guidance provided in the standards. This is our third in a series of publications which will provide detailed information on the key differences between Canadian GAAP and IFRS.

In this issue, property, plant and equipment issues will be presented with focus on:

- how to determine the cost of property plant and equipment,
- how to measure property, plant and equipment after initial recognition, including related accounting policy choices, and
- how to amortize property plant and equipment.

References

IFRS: IAS 16, IAS 40, IFRIC 1, IFRS 1

Canadian GAAP: Section 3061, Section 3831.

Introduction

Canadian GAAP and IFRS are similar in the treatment of property, plant and equipment.

However there are some major differences in the requirements such as:

- (i) Under Canadian GAAP properties held by an entity for rental or capital appreciations are treated the same as property, plant and equipment (i.e. Section 3061 applies). Under IFRS this type of property is accounted for



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separately from property, plant and equipment as it has its own standard, IAS 40 – Investment Property.

- (ii) Canadian GAAP and IAS 16 both require property, plant and equipment to be recorded at historical cost however there are different requirements for what expenditures are included or excluded from the historical cost.
- (iii) IAS 16 permits an entity to record property plant and equipment at a revalued (fair value) amount, something generally prohibited under Canadian GAAP.
- (iv) Component accounting, although not typically practiced under Canadian GAAP, is required under both Canadian GAAP and IFRS. The requirements under IFRS are more explicit than those in Section 3061. One such difference arises in the level or how the significant parts of an asset are to be separated. Canadian GAAP requires this when separable and practicable whereas IFRS requires separation based on its cost relative to the total cost of the asset.

In relation to property, plant and equipment there are specific elections that an entity is required to make on first time adoption of IFRS. These elections and options are not covered in this publication as they will be covered in a future publication; IFRS 1 – Making selections in a Canadian Context.

Scope and recognition

The definitions of property plant and equipment under Canadian GAAP (Section 3061) and IFRS (IAS 16) are very similar except in relation to one key item – Investment Properties.

Broadly investment properties are properties held by an entity for rental or capital appreciations. Under Canadian GAAP they are accounted for like property plant and equipment (i.e. in accordance with Section 3061). However, under IFRS these types of properties are specifically excluded from the property, plant and equipment standard (i.e. IAS 16). Investment Properties are accounted for under a separate IFRS standard, IAS 40. We will look at this type of property in more detail in one of our upcoming IFRS conversion series publications.

Canadian GAAP	IFRS
<p>The definition of property, plant and equipment is set out in paragraph 4 of Section 3061 – they are identifiable tangible assets that meet all of the following criteria:</p> <ul style="list-style-type: none"> - are held for use in the production or supply of goods and services, for rental to others, for administrative purposes or for the development, construction, maintenance or repair of other property, plant and equipment, - have been acquired, constructed or developed with the intention of being used on a continuing basis, and - are not intended for sale in the ordinary course of business. 	<p>The definition of property, plant and equipment is set out in paragraph 6 of IAS 16:</p> <p>They are tangible items that:</p> <ul style="list-style-type: none"> - are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and - are expected to be used during more than one period. <p>Items of property plant and equipment should be recognized as assets when the cost of an item of property, plant and equipment can be reliably measured and it is probable that the future economic benefits from the item will flow to the entity (IAS 16.7).</p>

Another difference between Canadian GAAP and IFRS is that IFRS is very explicit as to when the cost of an item of property plant and equipment should be recognized. The analysis below highlights these differences.

Initial Cost

In both Canadian GAAP and IFRS an entity is required to initially record property, plant and equipment that qualify for recognition at cost.

The requirements on how to measure the initial cost of an asset recognized as property, plant and equipment are very similar. As an example, directly attributable costs should be included under both Canadian GAAP and IFRS (IAS 16.17). However, the two standards differ in certain areas:

One of the major differences is in relation to what asset retirement obligations are included and/or excluded from initial cost. Under Canadian GAAP, the initial cost of property, plant and equipment includes legal obligations (Section 3110). Similarly IFRS requires legal obligations to be included in the initial cost. However, IFRS also requires constructive obligations to be included (IAS 16.16(c)).

IFRS is also more explicit in prescribing that certain costs are specifically excluded from the cost of the asset, including costs of opening a new facility; costs of introducing a new product or service (including costs of advertising and promotional activities); costs of conducting business in a new location or with a new class of customer (including costs of staff training); and administration and other general overhead costs (IAS 16.19).

Under Canadian GAAP (Section 3061.17) if the cost of the asset acquired other than through a business combination is different from its tax basis on acquisition, the asset's cost would be adjusted to reflect the related future income tax consequences (see Section 3465). IFRS does not include guidance on this.

Another difference is in relation to pre-asset ready income and expenses. Under Canadian GAAP (Section 3061.25) all net revenue or expenses derived from an item of property, plant and equipment prior to substantial completion and readiness for use to always be included in the cost of the asset. IFRS requires the income and/or expenses of insignificant operations (i.e. those not necessary in bringing the asset to the location and condition for it to be capable of operating in the manner intended by management) to be recognized directly in profit and loss and not in the cost of the asset (IAS 16.21).

Canadian GAAP and IFRS are also slightly different in relation to the treatment of borrowing costs. Under paragraph 23 of Section 3061 costs directly attributable to the acquisition, construction, or development activity over time are included in the initial cost. Therefore interest costs may be included in cost when the entities accounting policy is to capitalize interest costs, IFRS under the revised IAS 23 – Borrowing costs does not allow a choice. An entity must capitalize interest for certain qualifying assets.

Both Canadian GAAP and IFRS include guidance on how to measure an asset exchanged or transferred in a non-monetary transaction at the fair value of the asset given up. Under Canadian GAAP, except in certain situations very generally under Section 3831 an entity should measure an asset exchanged or transferred in a non-monetary transaction at the more reliably measurable of the fair value of the asset given up and the fair value of the asset received. For the most part IFRS is similar to Canadian GAAP. However, under IAS 16 an entity is required to measure an asset exchanged or transferred in a non-monetary transaction at the fair value of the asset given up, unless the fair value of the asset received is more clearly evident (IAS 16.26).

Canadian GAAP and IFRS are similar in relation to recognizing replacement costs in the carrying amount of an asset. However, IFRS is more explicit than Canadian GAAP in relation to the treatment of any cost of servicing an asset for operation.

Measurement after recognition – Cost or revaluation

The requirements of Canadian GAAP and IFRS for measuring an item of property, plant and equipment subsequent to its initial recognition are very different. Canadian GAAP uses the historical cost method and, except for comprehensive revaluations under Section 1625, does not allow any revaluation.

IFRS requires an entity to make a policy choice in relation to each class of asset included in property, plant and equipment. While IAS 16 allows an entity to use the historical cost method, IFRS also allows the use of a revaluation (fair value) method.

Like Canadian GAAP requirements under the IFRS cost method, an item of property, plant and equipment should be carried at its cost less any accumulated depreciation and any accumulated impairment losses (IAS 16.30). Under the IFRS revaluation method an item of property, plant and equipment should be carried at the fair value at the date of revaluation less any subsequent accumulated depreciation and any accumulated impairment losses (IAS 16.31).

While IFRS requires the policy choice (cost or revaluation) to be made and applied for each class of asset included in property plant and equipment (IAS 16.29) the standard provides only limited guidance on what makes up a class of assets (IAS 16.36). The standard sets out that a class of assets is a grouping of assets of a similar nature and use in an entity's operations. Common examples include:

- land,
- land and buildings,
- machinery,
- ships,
- aircraft,
- motor vehicles,
- furniture and fixtures, and
- office equipment.

Where an entity adopts the revaluation method all items in a class of assets should be revalued simultaneously and the revaluation should be performed with enough regularity to ensure that at the balance sheet date the carrying amount is not materially different from the fair value amount. As a result, a class of property, plant and equipment with significant unpredictable changes in fair value may require more frequent revaluations (e.g. every one or two years) than another class of asset that has stable or insignificant changes in fair value (e.g. a building may only require revaluation every 3 to 5 years).

In the case of land and buildings the fair value amount is usually determined by a professionally qualified market appraisal (IAS 16.32). Land and any asset situated on the land (e.g. building) are required to be accounted for as separate assets. Therefore any increases or decreases attributed to the land and buildings are also separately recognized.

If, due to the specialized nature of the item and the item being rarely sold, there is no market based evidence of fair value, an entity may estimate the fair value using an income or depreciated replacement cost method. A depreciated replacement cost method looks at how much it would cost to reproduce an asset after taking into account depreciation on the asset (e.g. the age of the asset relative to its estimated useful life and residual value) and also the utilization of the asset (e.g. physical, functional or technical obsolescence). When an entity uses this method to value an asset there is a greater risk that the valuation will result in an impairment loss (i.e. the value (depreciated replacement cost) of the asset will exceed its recoverable amount).

Where an entity has chosen the revaluation method the entity has two options available as to the treatment of any accumulated depreciation at the time of revaluation.

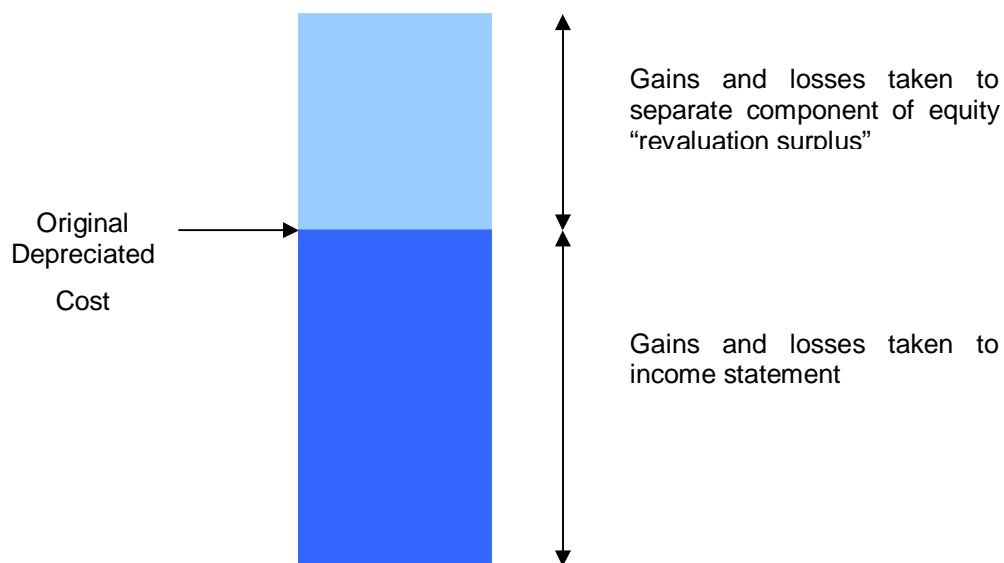
The entity may either:

- proportionally restate the carrying amount and accumulated depreciation, or
- offset the accumulated depreciation with the gross carrying amount (IAS 16.35).

The second approach above appears to be the preferred approach used by entities that have adopted revaluation of property, plant and equipment under IFRS. We believe an entity should make a choice and then consistently apply the treatment across all revaluations.

Whether the revaluation results in a revaluation surplus or deficit determines the accounting treatment. Any revaluation surplus for an asset is recognized separately in equity, unless the revaluation surplus is reversing a revaluation deficit previously recognized in profit and loss for the same asset (IAS 16.39). Any revaluation deficit should be firstly offset against any revaluation surplus for the same asset previously recognized in equity. Any excess should be recorded in profit and loss (IAS 16.40). Therefore, an entity can only offset revaluation surpluses and deficits for the same asset. Revaluation surplus and deficits of an entire class of property, plant and equipment cannot be offset.

The following diagram helps illustrate the different treatments:



An entity has another accounting policy choice to make in relation to the treatment or transfer of the revaluation surplus. Any revaluation surplus can only be transferred when an asset is derecognized or as the asset is used by the entity (usually the difference in depreciation on the revalued carrying amount and depreciation on the cost amount). This transfer is made directly from the revaluation surplus to retained earnings (i.e. is not recycled through profit and loss) (IAS16 41).

Therefore the entity needs to determine whether to:

- leave the reserve (i.e. revaluation reserve stays forever), or
- transfer the revaluation reserve on derecognition of the underlying asset, or
- transfer the revaluation reserve as the asset is being used (i.e. depreciated) with the remainder being transferred on derecognition of the underlying asset?

Depreciation

In both Canadian GAAP and IFRS the requirements for charging depreciation on property, plant and equipment are similar. However, a major difference exists between Canadian GAAP and IFRS in relation to how the depreciation charge is determined. Under Canadian GAAP depreciation is charged on the greater of i) cost less residual value over its estimated useful life, and ii) cost less salvage value (estimated net realizable value at the end of its life) over its estimated life. Under IFRS, depreciation is charged on the difference between the carrying value and the residual value over its estimated useful life.

Another difference in depreciation under Canadian GAAP and IFRS is in relation to how often the useful life, residual value and depreciation methods used need to be reviewed. Under Canadian GAAP the review is required periodically, when certain conditions exist. IFRS requires a review to be performed where expectations differ from previous estimates and at each annual reporting date.

Canadian GAAP	IFRS
<p>Depreciation of an asset is based on the greater of:</p> <ul style="list-style-type: none"> - cost less residual value (the estimated net realizable value at the end of its useful life) over its estimated useful life, and - cost less salvage value (estimated net realizable value at the end of its life) over its estimated life. 	<p>Unlike Canadian GAAP paragraph 6 of IAS 16 describes depreciation of an asset as the assets cost (or revalued cost) less its residual value over its estimated useful life.</p> <p>Estimates of residual values reflect prices at the reporting date given the condition the asset is expected to be in at the end of the useful life. Inflationary effects are not to be taken into account in determining the residual value.</p>
<p>Under Section 3061 the useful life and method of depreciation are reviewed periodically, and residual value is reviewed only when events or changes in circumstances indicate that the current estimates may no longer be appropriate.</p>	<p>Estimates of useful life and residual value, and the method of depreciation, are reviewed at least at each annual reporting date or where expectations differ from previous estimates (IAS 16.51)</p>
<p>Under Canadian GAAP (paragraph 13 of Section 3475) depreciation of an asset ceases when it is classified as held for sale.</p>	<p>Similar to Canadian GAAP under IFRS, depreciation of an asset begins when it is available for use and ceases when the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) (see IFRS 5) or when that asset is derecognized.</p>
<p>The objective of the depreciation method under Canadian GAAP is to provide a rational and systematic basis for allocating the amortizable amount of an item of property, plant and equipment over its estimated life (Section 3061.31).</p>	<p>IAS 16 is more explicit in relation to the depreciation method that should be used. An entity is required to select the depreciation method that closely reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity over its estimated useful life (IAS 16.60 to IAS 16.62).</p>

Components

In both Canadian GAAP and IFRS the requirements for charging depreciation on property, plant and equipment are similar, although in practice may be very different.

Both Canadian GAAP and IFRS require component accounting however the requirements under IFRS are much more explicit. As a result the total depreciation amount charged to the profit or loss statement will increase or decrease depending on the depreciation rates and methods used for each separate component. The following simple example illustrates the impact using component accounting can have on the depreciation charged.

Following the example used in paragraph 44 of IAS 16, which sets out that it may be appropriate to separate an aircraft into its airframe and engine components, assuming an entity purchases an aircraft for \$12m with the cost comprising the airframe (\$6.0m), the engine (\$4.0m) and other components which will be grouped together (\$2.0m). For the purposes of this example assume that the entity uses the straight line depreciation method, there is no residual value and the estimated useful lives of the components are:

- aircraft frame - 20 years;
- the engine component - 16 years, and
- the other component - 8 years.

The estimated useful life of the whole aircraft is 20 years, with no expected residual value.

Journal entry for when the aircraft was initially purchased

Canadian GAAP

Dr	Asset	12m	
	Cr	Bank/Liability	12m

IFRS

Dr	Aircraft – Airframe	6m	
Dr	Aircraft – Engine	4m	
Dr	Aircraft – Other	2m	
	Cr	Bank/Liability	12m

Journal entry to record depreciation:

Canadian GAAP

Dr	Depreciation	0.60m	
	Cr	Accumulated Depreciation	0.60m

IFRS

Dr	Depreciation Aircraft – Airframe	0.30m	
Dr	Depreciation Aircraft – Engine	0.25m	
Dr	Depreciation Aircraft – Other	0.25m	
	Cr	Accumulated Depreciation – Airframe	0.30m

Cr	Accumulated Depreciation – Engine	0.25m
Cr	Accumulated Depreciation – Air other	0.25m

As the above example illustrates the total amount of depreciation charged to the profit and loss may increase, in this example increasing from \$0.6m to \$0.8m.

These differences arising between Canadian GAAP and IFRS in relation to component accounting are summarized in the table below:

Canadian GAAP	IFRS
<p>Under paragraph 30 of Section 3061 component accounting is required for significant separable component parts of an item of property, plant and equipment when practicable and when estimates can be made of the lives of the separate components.</p> <p>Although very similar to the IAS 16 requirement, component accounting has typically not been practiced in Canada.</p>	<p>Similar to Canadian GAAP, component accounting is required for significant parts of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item (IAS 16.43).</p> <p>Component accounting is required if the useful life and/or depreciation method for the component is different from the remainder of the asset.</p>
<p>Under paragraph 17 of Section 3061, an entity is allowed to group together individually insignificant items of property plant and equipment where this is deemed appropriate.</p>	<p>Similar to Canadian GAAP, paragraph 47 of IAS 16 implies that insignificant items are grouped together for depreciation purposes. However, this paragraph also allows an entity to separately depreciate parts that have an insignificant cost in relation to the total cost. Therefore an entity is required to make choice as to whether to group or not group the insignificant components.</p> <p>Further to this IFRS is slightly different from Canadian GAAP in relation to grouping of significant components. IFRS allows an entity to group significant components of an item of property, plant and equipment where they have the same useful life and depreciation method. (IAS 16.45). There is no specific guidance on this under Canadian GAAP.</p>

A separate component may be either physical such, as an engine of a machine, or non physical, such as a major inspection or overhaul. As a result scheduled maintenance and refits would be treated as a separate component under IAS 16 and are amortized over the period between scheduled refits/maintenance. As no cost will be incurred at the date the component was acquired an estimate of the cost is required to determine the carrying amount. The estimate is based on the current market price of the refit/maintenance and not the expected market price (i.e. the estimated price when the maintenance will be performed). Once the scheduled refit or maintenance has taken place any remaining carrying amount (i.e. the unamortized portion) should be derecognized and a new refit/maintenance estimate capitalized.

Following the aircraft example, say the engine needs to have major maintenance every 5 years. At the date the engine was acquired the cost of maintenance for the same engine is \$1m. Therefore, the cost of \$1m would be capitalized and depreciated over the 5 year period.

The Future of Property, Plant and Equipment under IFRS

The IASB has issued an exposure draft of proposed amendments to International Financial Reporting Standards (IFRS). The amendments take various forms, including the clarification of the requirements of IFRS, the elimination of inconsistencies between Standards, and a restructuring of IFRS 1 First-time Adoption of IFRS. The proposed changes are to be effective for accounting periods commencing on/after January 1, 2009. Three changes are proposed in relation to IAS 16:

- (i) the definition of Recoverable amount is proposed to be changed so that it is consistent with the definition used in other IFRS. The proposed definition is “the higher of an assets fair value less costs to sell and its value in use.”
- (ii) the presentation of gains from the sale of assets held for rental is proposed to be changed. The gain would be classified as revenue, to better reflect the activities of a business that rents and subsequently sells assets.
- (iii) the third proposed amendment is a consequential change in relation to property purchased for the purpose of constructing or developing a future investment property. This type of property will no longer be included in the scope of IAS 16, but will be included in the scope of IAS 40 – Investment Property.

The IASB are also currently conducting a research project into fair value measurements in IFRS. A final product on this project may amend the current IAS 16 standard in relation to revaluation of assets. However, we do not anticipate this project will be completed by 2011

Conclusion

In general the principles related to property, plant and equipment under Canadian GAAP and IFRS are similar. However, significant differences do exist between the two standards including IFRS allowing for revaluation of assets; and component accounting. If you require further guidance on Impairment testing under IFRS or any other IFRS information or reference sources, please contact your local BDO Dunwoody LLP office or visit www.bdo.ca/ifrs.