



*Applying International Financial  
Reporting Standards  
to the Public Sector*

*Practical Examples  
of IFRS*

April 2004

**Disclaimer**

This publication is a guide based on information available as at 16 April 2004 and is not a substitute for the Pending Standards, exposure drafts, AASB and IASB Standards. Users of this publication should be aware that the requirements of IFRS could change over time until the release of final AASB equivalent of IFRSs. For further information, please refer to the AASB website.

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# INDEX

<b>BACKGROUND</b> .....	<b>1</b>
NOT FOR PROFIT EXEMPTIONS .....	1
<b>AASB 101 FIRST TIME ADOPTION OF AIFRPS</b> .....	<b>1</b>
PRESENTATION OF COMPARATIVE INFORMATION .....	1
RECOGNITION AND RECLASSIFICATION OF BALANCE SHEET ITEMS.....	2
<b>AASB 102 INVENTORIES</b> .....	<b>3</b>
MEASURING INVENTORIES HELD FOR DISTRIBUTION .....	3
<b>AASB 116 PROPERTY, PLANT AND EQUIPMENT</b> .....	<b>4</b>
FIXED ASSETS ON FIRST TIME ADOPTION.....	4
RECORDING ASSETS AT FAIR VALUE/DEEMED COST.....	5
RECORDING INCIDENTAL INCOME .....	6
IDENTIFYING CASH GENERATING UNITS .....	6
<b>AASB 119 EMPLOYEE BENEFITS</b> .....	<b>6</b>
<b>AASB 121 FOREIGN CURRENCIES</b> .....	<b>7</b>
IDENTIFYING FUNCTIONAL CURRENCIES .....	7
<b>AASB 132 AND 139 FINANCIAL INSTRUMENTS</b> .....	<b>7</b>
CLASSIFYING DEBT AND EQUITY INSTRUMENTS .....	7
<b>DRAFT AASB 136 IMPAIRMENT OF ASSETS</b> .....	<b>8</b>
DETERMINING RECOVERABLE AMOUNT.....	8
ASSET REVALUATIONS.....	8
CALCULATING IMPAIRMENT FOR GOODWILL AND OTHER ASSETS.....	9
<b>DRAFT AASB 138 INTANGIBLE ASSETS</b> .....	<b>10</b>
RECOGNISING INTERNALLY GENERATED INTANGIBLE ASSETS .....	10
AMORTISING RIGHTS TO INTANGIBLE ASSETS.....	10
CAPITALISING VS EXPENSING DEVELOPMENT COSTS ASSOCIATED WITH INTANGIBLES.....	11
<b>AASB 140 INVESTMENT PROPERTY</b> .....	<b>12</b>
<b>ED 117 DISPOSAL OF NON CURRENT ASSETS</b> .....	<b>13</b>
CLASSIFYING AN ASSET AS HELD FOR SALE .....	13
<b>ED 127 PROVISIONS, CONTINGENT LIABILITIES</b> .....	<b>13</b>
RECOGNISING A PROVISION .....	14
DISCLOSURE OF PROVISIONS AND CONTINGENCIES.....	16
<b>ED 128 TAX IMPLICATIONS</b> .....	<b>18</b>
GLOSSARY .....	19
REFERENCE LIST .....	19
QAO IFRS PUBLICATIONS .....	19

## BACKGROUND

This publication has been developed to provide public sector entities with practical examples of International Financial Reporting Standards (IFRS) applications. A critical issue that is being considered by central Government agencies throughout Australia is the 'for-profit' and 'not-for-profit' nature of entities in particular Government Owned Corporations. The definition of 'not-for-profit' includes all entities whose principal objective is not the generation of profit and may be a single entity or a group of entities. Pursuant to AASB 114 Aus 1.3, 'not-for-profit' entities include those to which AAS 27, AAS 29 and AAS 31 Standards apply. The assessment of the principal objective will be matter of professional judgement for central Government agencies, financial statement preparers and auditors.

The examples contained aims to distinguish the different accounting treatments under the existing Australian accounting framework and the International Accounting Standards Board (IASB) framework. The scenarios are primarily sourced from illustrative examples in the Pending Standards, exposure drafts and from presentations and workshops provided by various accounting bodies and international accounting firms. Practical examples have been provided in relation to the main aspects of the entity's operations including financial instruments; non-current assets; intangible assets; employee benefits; investment property; and the tax implication of transactions.

Pending Accounting Standards referred to throughout this publication are NOT yet law as they have not formally been made into legislation. Please note that the examples provided relate to information available as at April 2004.

### NOT FOR PROFIT EXEMPTIONS

The AASB's decision to include the relevant requirements of the International Public Sector Accounting Standards (IPSAS) issued by the International Federation of Accountants (IFAC) has resulted in a number of 'not-for-profit' specific requirements in individual Australian accounting standards. 'Non-for-profit' entities need to be aware of the specific exclusions and additional requirements in individual accounting standards.

## AASB 101 FIRST TIME ADOPTION OF AIFRPS

### PRESENTATION OF COMPARATIVE INFORMATION

#### 1. Question

Management has just installed a new computer information system throughout the entity that enables better allocation of costs, including overheads, to activities. Consequently, management is able to provide a more accurate and more detailed functional analysis of costs in its income statement for the current year. The new analysis is significantly different from the old analysis that the entity used. However, the new analysis is not available for the comparative information, although the current year information could be presented on the old, less informative basis if required.

Should an entity disclose information that results in a more appropriate presentation, yet detracts from the presentation of comparatives?

*Answer*

No, the current year information should be presented on the old basis of presentation for consistency with the comparative information. This will avoid the confusion that would be caused if different bases of presentation were used for the current year results and the comparative results. Additional information concerning the new analyses available can be included in the financial statements where this provides additional information and does not contradict the information in the primary statement.

The new analysis should be used in full in the following year when the new basis of presentation will be available for both years presented.

Source: PriceWaterhouseCoopers 'Applying IFRS – Solution 30.6

## RECOGNITION AND RECLASSIFICATION OF BALANCE SHEET ITEMS

### 2. Question

Review the balance sheet provided below for a not-for-profit entity to identify —

- the areas where adjustments are likely to be required;
- additional information which would be required; and
- which of the following four categories the balance falls into —
  - recognise assets and liabilities permitted by IFRS;
  - derecognise assets and liabilities not permitted by IFRS;
  - remeasure assets and liabilities in accordance with IFRS; and
  - reclassify assets and liabilities in accordance with IFRS.

	2005	2004
	\$	\$
<b>CURRENT ASSETS</b>		
Cash Assets	169,000	287,000
Receivables	140,000	89,000
Other	125,000	-
<b>TOTAL CURRENT ASSETS</b>	434,000	376,000
<b>NON-CURRENT ASSETS</b>		
Intangibles	35,000	60,000
Investment property	450,000	250,000
Plant and Equipment	78,000	63,000
<b>TOTAL NON-CURRENT ASSETS</b>	563,000	373,000
<b>TOTAL ASSETS</b>	997,000	749,000
<b>CURRENT LIABILITIES</b>		
payables	23,000	175,000
Provisions	75,000	115,000
Appropriations received in advance	140,000	156,000
Annual leave provision	65,000	200,000
<b>TOTAL CURRENT LIABILITIES</b>	303,000	646,000
<b>NON-CURRENT LIABILITIES</b>		
Provisions	32,000	38,000
<b>TOTAL NON-CURRENT LIABILITIES</b>	32,000	38,000
<b>TOTAL LIABILITIES</b>	335,000	684,000
<b>NET ASSETS</b>	662,000	65,000
<b>EQUITY</b>		
Revaluation reserve	210,000	170,000
retained profits	156,000	149,000
<b>TOTAL EQUITY</b>	366,000	319,000

Source: CPA Australia presentation (March 2004) – The Transition to IFRS: Preparing for Change: Accounting Standards and Financial Reporting Update for the Public Sector (notes developed by WalterTurnbull)

*Answer****Recognise assets and liabilities permitted by IFRS***

Since this category includes items which are not identified on the balance sheet, it is not possible to determine whether there are any additional items to recognise on the balance sheet based on the information provided. For example, items which would need to be considered for recognition on the balance sheet under IFRS include —

- Financial Instruments; and
- Defined Benefit (superannuation plan) Assets and Liabilities.

***Derecognise assets and liabilities not permitted by IFRS***

The composition of the intangible assets will need to be reviewed in accordance with the IFRS requirements to determine whether there are any internally generated intangibles, for example start up costs, advertising lists and internally developed software that need to be derecognised. In addition, IFRS does not permit research costs to be capitalised as in this regard, only development costs can be capitalised if certain criteria are met (for examples on the capitalisation of development costs, refer Questions 18 and 19).

***Remeasure assets and liabilities in accordance with IFRS***

This is the category which is likely to have most impact for not-for-profit entities. The areas of impact for this balance sheet would be —

- Other assets – need to determine the make-up of this balance and whether the valuation and recognition criteria are appropriate.
- Intangibles and plant and equipment – if the recognition criteria are met then the valuation of these items needs to be assessed under the IFRS framework. In particular, each of these assets should be reviewed to determine whether there are any impairment indicators, both external and internal, which may result in a write down.
- Investment property – the valuation basis of the investment property will need to be reviewed to ensure that the valuation and depreciation basis is consistent with IFRS. That is, valued using the fair value model or the cost model.
- Provisions – the impact of discounting of these non-current liabilities is insignificant, however, the need for discounting should be considered and in particular, the appropriateness of the current provisions to confirm the timing of the payment.

***Reclassify assets and liabilities in accordance with IFRS***

From a high level review, it is not possible to determine the need for reclassification of assets and liabilities. This is likely to have most impact in the area of financial instruments and therefore, most not-for-profit entities are not likely to be affected.

## AASB 102 INVENTORIES

### MEASURING INVENTORIES HELD FOR DISTRIBUTION

#### 3. Question

How are inventories held for distribution measured under AASB 102?

*Answer*

Under AASB 102 for a not-for-profit entity, inventories held for distribution must now be measured at the lower of cost and current replacement cost. This standard does not apply to work-in-progress of services to be provided for no or nominal consideration directly in return from the recipients.

Source: Parker, C. (December 2003) 'Not for Profits must take heed of IFRS' on [www.cpaaustralia.com.au](http://www.cpaaustralia.com.au)

## AASB 116 PROPERTY, PLANT AND EQUIPMENT

(extracts from AASB 1) Fair Value or revaluation as deemed cost

16. An entity may elect to measure an item of property, plant and equipment at the date of transition to AIFRPs at its fair value and use that fair value as its deemed cost at that date. (Refer Question 4, Asset 1).
17. A first-time adopter may elect to use a previous GAAP revaluation of an item of property, plant and equipment at, or before, the date of transition to AIFRPs as deemed cost at the date of the revaluation (refer Asset 3), if the revaluation was, at the date of the revaluation, broadly comparable to —
- (a) fair value; or
  - (b) cost or depreciated cost under AIFRPs, adjusted to reflect, for e.g. changes in a general / specific price index.
18. The elections in para. 16 and 17 (above) are also available for —
- (a) an investment property, if an entity elects to use the cost model in AASB 140; and
  - (b) intangible assets that meet —
    - (i) the recognition criteria in AASB 138; and
    - (ii) the criteria in AASB 138 for revaluation.

An entity shall not use these elections for other assets or for other liabilities.

Source: Pending Standard AASB 1 First Time Adoption of Australian International Financial Reporting Pronouncements.

### FIXED ASSETS ON FIRST TIME ADOPTION

Current Australian measurement basis	Measurement basis under IFRS	Conditions	Accounting treatment on transition
Historical cost	Cost	Cost must reflect IFRS rules	Ensure cost reflects IFRS rules. Adjustments to retained profit.
	Deemed cost	Fair value at transition	Eliminate accumulated depreciation and adjust carrying amount to reflect fair value. Adjustments to retained profit.
	Fair value	Fair value at transition	
Fair value	Deemed cost	Latest revaluation must approximate fair value at the date of revaluation	No material accounting adjustments so long as regular revaluations have taken place.
	Fair value	Fair value at transition	No material accounting adjustments so long as regular revaluations have taken place.
Revaluation used as deemed cost on the adoption of AASB 1041	Deemed cost	Revaluation must have been comparable to Fair value at the revaluation date; if not use the option below	No adjustments.
	Deemed cost	Fair value at transition	Eliminate accumulated depreciation and adjust carrying amount to reflect fair value.
	Fair value	Fair value at transition	Eliminate accumulated depreciation and adjust carrying amount to reflect fair value. Adjustments to revaluation reserve.

**RECORDING ASSETS AT FAIR VALUE/DEEMED COST**
**4. Question**

The following question contains three assets – Assets 1, 2 and 3. Assume that each of these assets has satisfied the recognition criteria under IFRS. Prepare journal entries to reflect each of these scenarios at transition —

**Asset 1**

Held at Cost	124, 000
Accumulated Depreciation	(25, 000)
Fair Value	140, 000

(Entity M wishes to use the deemed cost measurement basis under IFRS)

**Asset 2**

Held at Fair Value	250, 000
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(Entity M wishes to continue to hold the asset at fair value)

**Asset 3**

Held at deemed cost	330, 000
Accumulated Depreciation	(45, 000)
Fair Value	300, 000

(The revaluation to deemed cost was not broadly comparable to the fair value of the asset at the date of deemed cost since, at the adoption of AASB 1041, the carrying value of the asset was taken to be deemed cost. Entity M wants to continue to show the asset at fair value).

*Answer*
**Asset 1**

Entity M needs to eliminate accumulated depreciation on the asset and adjust the carrying amount to reflect fair value. Adjustments need to be made to retained earnings.

Dr	Accumulated Depreciation	25, 000	
Cr	Asset		25, 000
Dr	Asset	41, 000	
Cr	Retained Earnings		41, 000

**Asset 2**

Since regular revaluations are conducted, no adjustments are necessary.

**Asset 3**

Dr	Accumulated Depreciation	45, 000	
Cr	Asset		45, 000
Dr	Asset	15, 000	
Cr	Asset Revaluation Reserve		15, 000

Entity M needs to eliminate the accumulated depreciation on the asset and adjust the carrying amount of the asset to reflect the fair value. Adjustments are reflect in the asset revaluation reserve.

Note — Not-for-profit entities are exempt from the requirement to disclose the cost of property, plant and equipment where that class has been revalued whereas for-profit entities are required to disclose the cost of revalued assets.

Source: CPA Australia presentation (March 2004) – The Transition to IFRS: Preparing for Change: Accounting Standards and Financial Reporting Update for the Public Sector (notes developed by WalterTurnbull)

## RECORDING INCIDENTAL INCOME

### 5. Question

An Entity bought a plot of land for development of office buildings. Development of the land was scheduled into six phases. The land scheduled for development in phases five and six was leased to another entity on a short-term basis as a parking lot for heavy vehicles.

Should incidental income earned during the testing or pre-production phase be deducted from the cost of the asset?

*Answer*

Rental income from the car park lease is recognised in the income statement for the period. The car park activity is incidental to the entity's principal activity of property development. Operations that are incidental to the construction or development of property, plant and equipment are not necessary to bring the asset to its working condition for the intended use. The income and related expenses of incidental operations are recognised in the income statement for the period, and included in their respective classifications of income and expense in the income statement.

Source: CA Business Forum, 12 March 2004 by the ICAA, presented by PwC (slide 21)

## IDENTIFYING CASH GENERATING UNITS

Where indication of an impairment of asset exists, its recoverable amount must be determined but where it is *not possible* to identify an individual asset's recoverable amount, then its value must be determined for the asset's cash-generating unit (CGU). Refer to the Glossary section of this publication for the definition of a CGU.

### 6. Question

A mining company owns a private railway to support its mining activities. The private railway could be sold only for scrap value and it does not generate cash inflows from continuing use that are largely independent of the cash inflows from the other assets of the mine. What is the Cash Generating Unit (CGU)?

*Answer*

The value in use of the private railway cannot be determined since it is probably different from the scrap value and does not generate cash inflows independently. The CGU is therefore, likely to be the mine as a whole.

### 7. Question

What is the CGU in this example —

An entity is in the business of providing National Parks to the Public and communities. It owns a headquarters building that was previously fully occupied for internal purposes. Following a downsizing exercise, half of the office space is now used internally and half is rented to external parties. The lease agreement with the tenants is for 10 years.

*Answer*

The principal purpose of the building is as a corporate asset for the entity to support its Park activity and business. Therefore, the building as a whole cannot be considered to generate cash inflows that are largely independent from the cash flows from the entity as a whole. The CGU is therefore, likely to be the building as a whole.

## AASB 119 EMPLOYEE BENEFITS

### 8. Question

Entity A's first IFRS financial statements have a reporting date of 31 December 2005 and include comparative information for one year. In its financial statements for 31 December 2003 and 2004, entity A accounted for its defined benefit pension plan on a cash basis. In preparing its opening IFRS balance sheet at 1 January 2004, and in its comparative balance sheet as at 31 December 2004, entity A needs to make estimates (in the form of actuarial assumptions) necessary to account for the pension plan under IAS 19 Employee Benefits. What conditions and what dates are not included in making actuarial assumptions at 1 January 2004 and 31 December 2004?

*Answer*

The actuarial assumptions at 1 January 2004 and 31 December 2004 should not reflect conditions that arose after those dates —

- Discount rates at 1 January 2004 and 31 December 2004 for the pension plan and for provisions should reflect the market conditions at those dates; and
- Actuarial assumptions at 1 January 2004 and 31 December 2004 regarding future employee turnover rates should not reflect conditions that arose after those dates – such as a significant increase in estimated employee turnover rates resulting from a decrease in salary increase percentages due to difficult trading conditions in 2005.

Source: Ernst & Young, October 2003, Accounting Brief, page 12

## AASB 121 FOREIGN CURRENCIES

### IDENTIFYING FUNCTIONAL CURRENCIES

#### 9. Question

A parent entity is incorporated and listed in Australia. The parent's only activities are to hold investments in subsidiaries and to raise finance to fund its investments. The parent entity has three subsidiaries which have their operations in the US. The subsidiaries provide a range of services to the public. Management has historically prepared the financial statements for the parent entity and the group in Australian dollars, before the transition to IFRS. Recently, the parent entity acquired another subsidiary, which it financed through the issue of US dollar bonds. The new subsidiary also has operations in the US. What is the functional currency for the parent entity?

*Answer*

- Based on the information provided, the functional currency (used to measure the items in a financial report) used by the parent is most likely to be US dollar.
- The parent entity does not seem to have any substantive operations or cash flows of its own.
- Management must determine the parent's functional currency by considering the operations of the group as a whole and not just the operations of the individual parent entity.

## AASB 132 AND 139 FINANCIAL INSTRUMENTS

### CLASSIFYING DEBT AND EQUITY INSTRUMENTS

#### 10. Question

An entity issues a 1, 000, 000 zero-coupon rate, five year bond. The amount of 1, 000, 000 can be settled at the issuer's option either in cash or with its own equity shares with a market value that is equivalent to 1, 000, 000 at the end of the five years.

Should a contractual obligation that requires settlement using an entity's own shares be classified as equity.

*Answer*

No. The bond is a liability because it exposes its issuer to fluctuations in the price of its shares between the issue date and exercise date. Conversely, it does not expose the holder of the instrument to the risk of a fluctuation in the price of the ordinary shares. An instrument must expose the holder to equity risk to be classified as equity by the issuer. In this example, the holder receives either cash or a fixed number of equity shares equivalent to the amount of the obligation.

Source: CA Business Forum, 12 March 2004 by the Institute of Chartered Accountants in Australia (ICAA), presented by PriceWaterhouseCoopers

## DRAFT AASB 136 IMPAIRMENT OF ASSETS

### DETERMINING RECOVERABLE AMOUNT

#### 11. Question

A machine has suffered physical damage but is still working, although not as well as it previously did. The net selling price of the machine is less than its carrying amount. The machine does not generate independent cash inflows from continuing use. The smallest identifiable group of assets that includes the machine and generates cash inflows from continuing use that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. The recoverable amount of the production line shows that the production line taken as a whole is not impaired.

What are the implications of management's commitment to replace or not replace the machine?

*Answer*

**Assumption 1** — budgets/forecasts approved by management reflect no commitment of management to replace the machine. In this scenario, the recoverable amount of the machine alone cannot be estimated since the machine's value in use —

- May differ from its net selling price; and
- Can be determined only for the cash-generating unit to which the machine belongs (the production line).

The production line is not impaired, therefore, no impairment loss is recognised for the machine. Nevertheless, the entity may need to reassess the depreciation period or the depreciation method for the machine. Perhaps, a shorter depreciation period or a faster depreciation method is required to reflect the expected remaining useful life of the machine or the pattern in which economic benefits are consumed by the entity.

**Assumption 2** — budgets/forecasts approved by management reflect a commitment of management to replace the machine and sell it in the near future. Cash flows from continuing use of the machine until its disposal are estimated to be negligible. In this scenario, the machine's value in use can be estimated to be close to its net selling price. Therefore, the recoverable amount of the machine can be determined and no consideration is given to the cash-generating unit to which the machine belongs, (i.e. the production line). Since the machine's net selling price is less than its carrying amount, an impairment loss is recognised for the machine.

Source: IAS 36 Impairment of Assets

### ASSET REVALUATIONS

#### 12. Question

Under IAS 16, property, plant and equipment may be revalued to fair value or carried at cost. Revaluation increments and decrements can only be offset within the Asset Revaluation Reserve balance for the same asset class. Refer example.

Example – Assets A and B are in the same class.

A increment is \$1,000,000

B decrement is \$1,200,000

How will this be accounted for under existing Australian accounting standards versus under IFRS for a 'not-for-profit' and – 'for-profit' entity?

*Answer*

In Australia —

Dr	Asset A	1 000 000	
Dr	Expense (Profit and Loss)	200 000	
Cr	Asset B		1 200 000

Note: The net decrement for the asset class is \$200, 000. Assuming that this decrement is not a reversal of the previous revaluation increment for the same class, or to the extent that there is no balance of any previous revaluation increment for the class remaining in the asset revaluation reserve, the decrement is recognised as an expense. Otherwise, the debit entry for \$200, 000 would be made to the asset revaluation reserve, to the extent of the credit balance in the reserve that relates to the same asset class.

Under IFRS for a 'not-for-profit' entity —

Dr	Asset A	1 000 000	
Dr	Expense (Profit and Loss)	200 000	
Cr	Asset B		1 200 000

Note: There is no change in treatment for 'not-for-profit' entities under IFRS.

Under IFRS for a 'for-profit' entity (assuming no previous increments for Asset B) —

Dr	Asset A	1 000 000	
Cr	Asset Revaluation Reserve		1 000 000
Dr	Expense (Profit and Loss)	1 200 000	
Cr	Asset B		1 200 000

Note – assets have to be revalued on an asset-by-asset basis for the 'for-profit' sector. For 'not-for-profit' entities, the revaluation will be for an entire class of property, plant and equipment to which that asset belongs i.e. no change to existing treatment.

Source: CPA Australia presentation (March 2004) – The Transition to IFRS: Preparing for Change: Accounting Standards and Financial Reporting Update for the Public Sector (notes developed by Walter Turnbull)

## CALCULATING IMPAIRMENT FOR GOODWILL AND OTHER ASSETS

### 13. Question

Entity F conducts annual impairment testing of its assets. At the time of an annual impairment test, the entity has a CGU with a book value of \$1.9 million which includes goodwill at \$0.4 million.

The recoverable amount of the CGU has been calculated as follows —

	\$ million
Book value of the CGU (inclusive of goodwill)	1.9
Recoverable amount of the CGU	1.4
Net fair value of the CGU	1.2

Calculate the impairment for goodwill and other assets as applicable.

*Answer*

The impairment amount is as follows —

	\$ million
Recoverable amount of the CGU	1.4
Less carrying amount of the CGU (including goodwill)	1.9
Impairment loss of the CGU	(0.5)

An impairment loss of \$0.5m is recognised immediately in the profit and loss account. The carrying amount of the goodwill that relates to the CGU is reduced by the amount of the goodwill \$0.4m to nil.

The carrying amounts of other identifiable assets within the CGU are reduced by the remaining impairment loss of \$0.1m. This loss is allocated across these assets proportionately, based on the assets' carrying amounts.

## DRAFT AASB 138 INTANGIBLE ASSETS

### RECOGNISING INTERNALLY GENERATED INTANGIBLE ASSETS

#### 14. Question

An entity which has a reporting date of 31 December is developing a new production process. During 20X5, expenditure incurred was \$1,000 of which \$900 was incurred before 1 December 20X5 and \$100 was incurred between 1 December 20X5 and 31 December 20X5. The entity is able to demonstrate that, at 1 December 20X5 the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be \$500.

What is the cost of the internally generated intangible asset recognised on the balance sheet?

*Answer*

At the end of 20X5, the production process is recognised as an intangible asset at a cost of \$100 (expenditure incurred since the date when the recognition criteria were met, that is, 1 December 20X5). This amount does not exceed the recoverable amount of \$500, therefore, no impairment write-down is required. The \$900 of expenditure before 1 December 20X5 is recognised as an expense because the recognition criteria were not met until 1 December 20X5. This \$900 expenditure is likely to have been research, therefore, must be expensed. This expenditure of \$900 will never form part of the cost of the production process recognised in the balance sheet.

Source: IAS 38 Intangible Assets

#### 15. Question

This question follows from the previous question.

During 20X6, expenditure incurred on the production process is \$2,000. At the end of 20X6, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be \$1,900. What is the cost of the production process at the end of 20X6?

*Answer*

At the end of 20X6, the cost of the production process is \$2,100 (\$100 expenditure recognised at the end of 20X5) plus \$2,000 expenditure recognised in 20X6). The enterprise recognises an impairment loss of \$200 to adjust the carrying amount of the process before impairment loss (\$2,100) to its recoverable amount of \$1,900. This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in IAS 36 Impairment of Assets is met.

### AMORTISING RIGHTS TO INTANGIBLE ASSETS

#### 16. Question

An entity has purchased an exclusive right to generate hydro-electric power for sixty years. The costs of generating hydro-electric power are much lower than the costs of obtaining power from alternative sources. It is expected that the geographical area surrounding the power station will demand a significant amount of power from the power station for at least sixty years.

Over how many years should the entity amortise the right to generate power?

*Answer*

The entity should amortise the right to generate power over sixty years, unless there is evidence that its useful life is shorter.

#### 17. Question

An entity has purchased an exclusive right to operate a toll motorway for thirty years. There is no plan to construct alternative routes in the area served by the motorway. It is expected that this motorway will be in use for at least thirty years. Over how many years should the entity amortise the right to the motorway?

*Answer*

The entity should amortise the right to operate the motorway over thirty years, unless there is evidence that its useful life is shorter.

**CAPITALISING VS EXPENSING DEVELOPMENT COSTS ASSOCIATED WITH INTANGIBLES****18. Question**

An entity is in the process of developing a new time recording system for its warehouse. This will enable timesheets to be completed, approved and reviewed on line and will be a 'smart' system which alerts the staff member when a timesheet has not been completed for the week.

A project team has been established whose sole responsibility is the completion of this system and they are approximately 65% complete. This project team comprises suitably qualified staff to complete the development of the system. What costs associated with this development should be capitalised under IFRS?

*Answer*

To determine whether the costs associated with this development / project should be capitalised under the IFRS framework, the entity must demonstrate that each of the following criteria has been met —

- **Technical feasibility of completing the asset** – the project is 65% complete and a project team has been established with the responsibility to complete the development of the system. Therefore satisfied.
- **Its intention to use or sell the asset** – as mentioned in the question, the entity intends to use the system in the warehouse.
- **Its ability to use or sell the asset** – since the product has been developed in-house for the specific needs of the entity, then the ability to use it will be quite high.
- **How the asset will generate future economic benefits** – the entity will use the time recording system in its warehouse and the 'smart' functionality will enable staff to complete timesheets on time and efficiency, which in turn, will generate efficiencies to the entity.
- **The availability of adequate technical, financial and other resources to complete the development and to use or sell the asset** – as mentioned in the question, the project team comprises suitably qualified staff and the entity is committed to completing the project.
- **Its ability to reliably measure the expenditure attributable to the asset during its development** – the project team have been given the responsibility to complete the development of this system as their main objective, and therefore, we can assume that their wages and time spent on the project, can be separately identified.

Based on this analysis of this criteria, it is likely that the development costs in relation to this project can be capitalised.

Source: CPA Australia presentation (March 2004) – The Transition to IFRS: Preparing for Change: Accounting Standards and Financial Reporting Update for the Public Sector (notes developed by Walter Turnbull)

**19. Question**

An entity has performed market research and determined that its clients would like to have an inventory management system which sends out a reminder to them when their stock levels fall below a certain pre-determined limit.

The final design of the project has been determined by the entity, but it has not taken the product to its customers to determine whether the design and functionalities are sufficient and appropriate for the customers' needs. A project team has been established to manage this project.

The entity is confident that it has the staff expertise to be able to complete the project and sell the final product.

*Answer*

Applying the same criteria as in Question 18, the following is noted —

- **Technical feasibility of completing the asset** – based on the market research performed, the system should be technically feasible
- **Its intention to use or sell the asset** – the entity intends to sell the asset to its customers.
- **Its ability to use or sell the asset** – although the customers have indicated their desire for this product, the asset itself has not been costed and the specific requirements of the customers have not been confirmed, therefore, the entity's ability to sell the asset cannot be determined.
- **How the asset will generate future economic benefits** – if the entity was able to sell the asset, the entity will generate revenue from the sale.

- **The availability of adequate technical, financial and other resources to complete the development and to use or sell the asset** – a project team of staff with technical expertise has been developed to manage the project.
- **Its ability to reliably measure the expenditure attributable to the asset during its development** – we can assume that the wages and time spent on the project can be separately identified.

The entity did not satisfy the criteria – the ability to sell or use the asset, therefore, it is not able to capitalise the expenditure. It is important to note that no intangible asset arising from the research phase shall be recognised, as expenditure on research is to be expensed when incurred.

Source: CPA Australia presentation (March 2004) – The Transition to IFRS: Preparing for Change: Accounting Standards and Financial Reporting Update for the Public Sector (notes developed by WalterTurnbull)

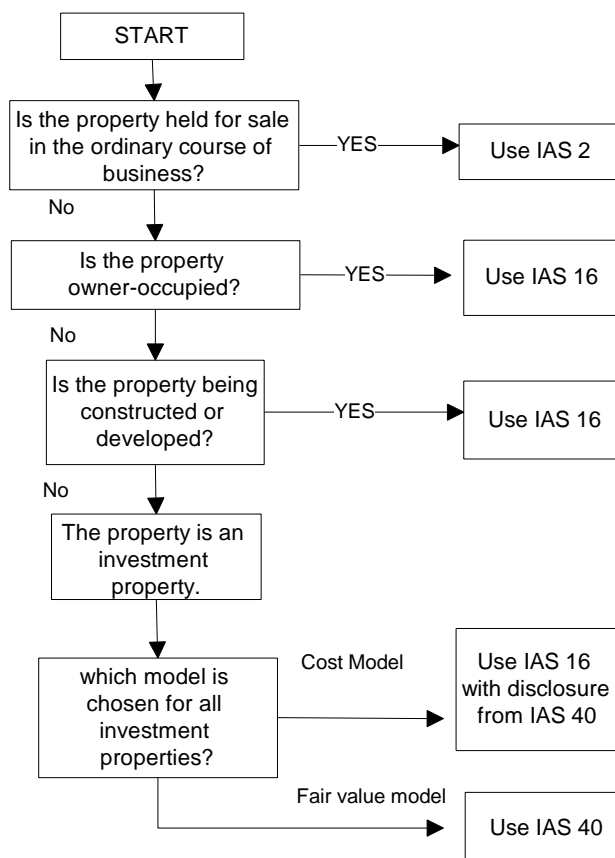
## AASB 140 INVESTMENT PROPERTY

### 20. Question

Which International Accounting Standards apply to which kinds of property?

*Answer*

The following decision tree summarises which International Accounting Standards apply to various kinds of property.



Source: IAS 40 Investment Property, Appendix A

Note: Under AASB 140 para. Aus 9.1, in respect of 'not-for-profit' entities, property may be held to meet service delivery objectives rather than to earn rental or other capital appreciation. In such situations, the property will not meet the definition of investment property and will be accounted for under AASB 116, for example —

- property held for strategic purposes; and
- property held to provide a social service, including those which generate cash inflows where the rental revenue is incidental to the purpose for holding the property.

## ED 117 DISPOSAL OF NON CURRENT ASSETS

An entity must classify a non-current asset as held for sale if its carrying amount will be recovered principally through a sale transaction (which includes exchanges of assets for other non-current assets) rather than through continuing use.

Source: ED 117 Disposal of Non-current Assets and Presentation of Discontinued Operations

### CLASSIFYING AN ASSET AS HELD FOR SALE

#### 21. Question

An entity is committed to a plan to sell its headquarters building and has initiated actions to locate a buyer. The agency will continue to use the building until construction of a new headquarters is completed. The agency does not intend to transfer the existing building to a buyer until after construction of the new building is completed (and it vacates the existing building).

Is the entity required to classify the asset in question as held for sale?

*Answer*

The delay in the transfer of the existing building imposed by the seller demonstrates that the building is not available for immediate sale. This criterion would not be met until the new building is constructed, even if a firm purchase commitment for the future transfer of the existing building is obtained earlier.

#### 22. Question

Entity S is committed to a plan to sell a non-current asset and classifies the asset as held for sale at that date. In the following year, the market conditions deteriorated from the date that the asset was classified initially as held for sale and as a result of the conditions, the asset is not sold by the end of that period.

During that period, entity S actively solicited but did not receive any reasonable offers to purchase the asset and, in response, reduced the price.

*Answer*

The asset continues to be actively marketed at a price that is reasonable, given the change in market conditions, and the criterion (the asset is marketed at a price that is reasonable to its current fair value) is therefore met. In that situation, an exception to the one year rule could be used. At the end of the initial one year period, the asset would continue to be classified as held for sale.

Note: if the asset price was not reduced to match the deteriorated market conditions then the asset would have to be reclassified to being held for use.

## ED 127 PROVISIONS, CONTINGENT LIABILITIES

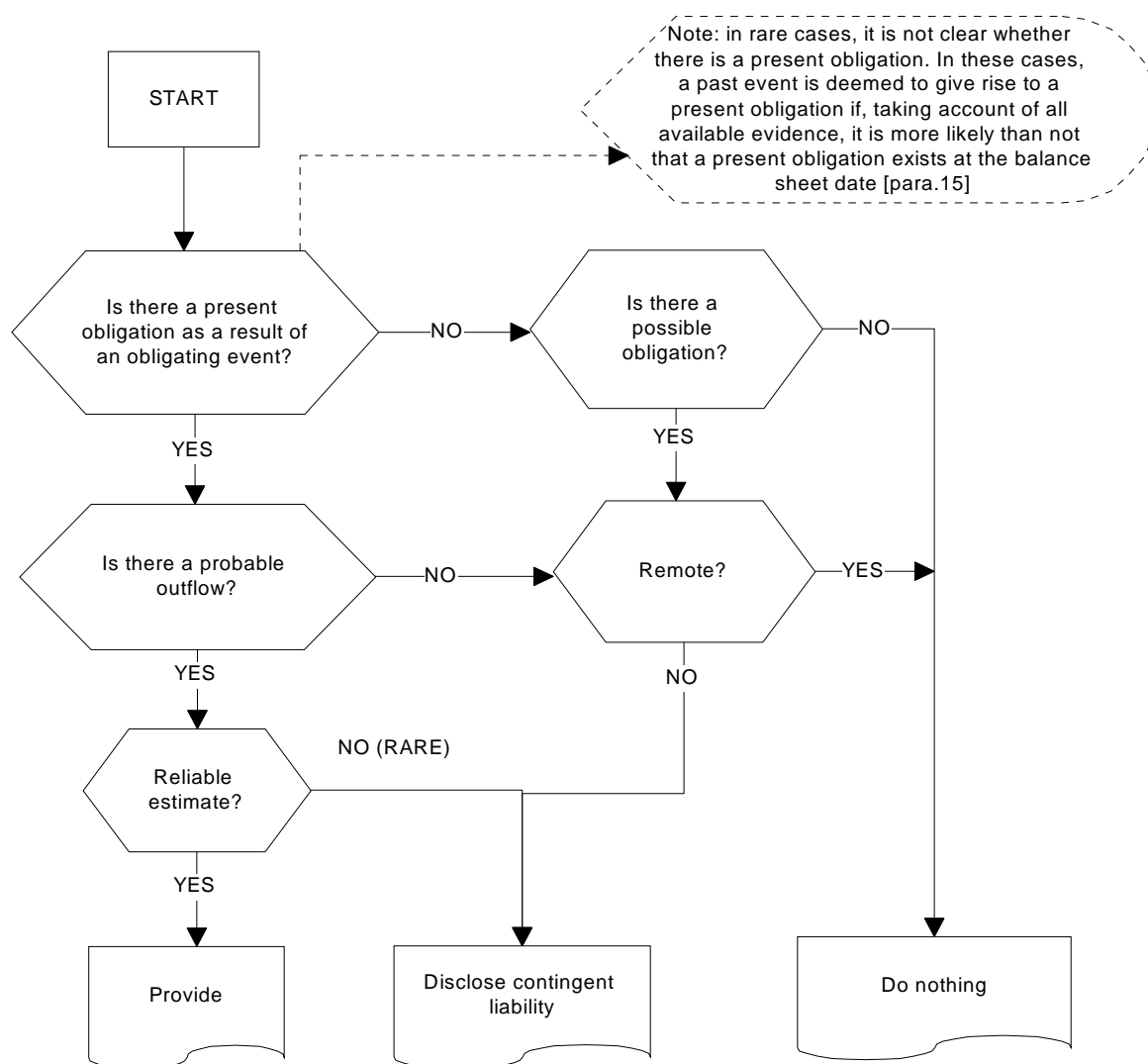
**Note** — All examples in this section have been adopted from ED 127 Request for Comment on IAS 37 Provisions, Contingent Liabilities and Contingent Assets. All the entities in this section have 31 December year ends. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some examples, the circumstances described may have resulted in impairment of the assets – this aspect is not dealt with in the examples. References provided in the examples indicate paragraphs of the proposed Standard that are particularly relevant. References to ‘best estimate’ are to the present value amount, where the effect of the time value of money is material.

#### 23. Question

What are the main recognition requirements of the proposed Standard for provisions and contingent liabilities?

*Answer*

Appendix B of ED 127 Request for Comment on IAS 37 Provisions, Contingent Liabilities and Contingent Assets provides a decision tree which summarises the main recognition requirements of the Standard for provisions and contingent liabilities. The decision tree is illustrated below —



## RECOGNISING A PROVISION

### 24. Question

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known. Should the store recognise a provision?

*Answer*

The obligating event is the sale of the product, which gives rise to a constructive obligation because the conduct of the store has created a valid expectation on the part of its customers that the store will refund purchases. It is also probable that a proportion of goods are returned for refund [paragraph 24]. A provision should be recognised for the best estimate of the costs of refunds [paragraphs 10, 14, 17 and 24].

### 25. Question

On 12 December 2000, the board of an entity decided to close down a division. Before the balance sheet date (31 December 2000), the decision was not communicated to any of those affected and no other steps were taken to implement the decision. Should a provision be recognised?

*Answer*

Given the decision was not communicated, there has been no obligating event and so there is no obligation. No provision is recognised [paragraphs 14 and 72].

## 26. Question

On 12 December 2000, the board of directors decided to close down a division making a particular product. On 20 December 2000, a detailed plan for closing down the division was agreed by the board, letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division. Should a provision be recognised?

### *Answer*

The obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed. In addition, it is probable that an outflow of resources embodying economic benefits in settlement will result. A provision should be recognised as at 31 December 2000 for the best estimate of the costs of closing the division [refer paragraphs 14 and 72].

## 27. Question

Some assets require, in addition to routine maintenance, substantial expenditure every few years for major refits or refurbishment and the replacement of major components. Pending accounting standard AASB 116 Property, Plant and Equipment gives guidance on allocating expenditure on an asset to its component parts where these components have different useful lives or provides benefits in a different pattern.

An airline is required by law to overhaul its aircraft once every three years. As a result of the legislative requirement, should the airline record a provision?

### *Answer*

There is no present obligation as there is no past obligating event, therefore, no provision is recognised. The legal requirement to overhaul the aircraft does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity's future actions – i.e. the airline could avoid the future expenditure by its future actions, for example, by selling the aircraft. Instead of a provision being recognised, the depreciation of the aircraft takes account of the future incidence of maintenance costs i.e. an amount equivalent to the expected maintenance costs is depreciated over three years.

## 28. Question

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years. Is there a present obligation and should a provision be recognised?

### *Answer*

There is no present obligation resulting from a past obligating event and no provision is recognised. The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions – even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognised, the depreciation of the lining takes account of its consumption i.e. it is depreciated over five years. The re-lining costs then incurred are capitalised with the consumption of each new lining shown by depreciation over the subsequent five years.

## 29. Question

The government introduces a number of changes to the income tax system. As a result of these changes, an enterprise in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place. Is there a present obligation?

### *Answer*

There is no obligation because no obligating event (e.g. compulsory retraining) has taken place, and therefore, no provision is recognised.

### 30. Question

An entity operates a factory profitably that it has leased under an operating lease. During December 2000 the entity relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user. Does this situation give rise to a provision?

*Answer*

The obligating event is the signing of the lease contract, which gives rise to a legal obligation. When the lease becomes onerous, an outflow of resources embodying economic benefits is probable. A provision is therefore, recognised for the best estimate of the unavoidable lease payments [refer paragraphs 5c, 14 and 66].

### 31. Question

During 1999, an entity A gives a guarantee of certain borrowings of entity B, whose financial condition at that time is sound. During 2000, the financial condition of entity B deteriorates and at 30 June 2000, entity B files for protection from its creditors. What is the treatment under the proposed Standard?

#### At 31 December 1999

The obligating event is the giving of the guarantee, which gives rise to a legal obligation. As at 31 December 1999, if the outflow of benefits is not probable and is considered to be remote, then no action is required. However, if the outflow of benefits is not probable and not remote, then a contingent liability will need to be disclosed. (Refer decision chat under Question 23).

#### At 31 December 2000

The obligating event is the giving of the guarantee, which gives rise to a legal obligation. At 31 December 2000, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation. A provision is recognised for the best estimate of the obligation [refer paragraphs 14 and 23].

If the entity has a portfolio of guarantees, it will assess that portfolio as a whole in determining whether an outflow of resources embodying economic benefits is probable [paragraph 24]. Where an entity gives guarantees in exchange for a fee, revenue is recognised.

## DISCLOSURE OF PROVISIONS AND CONTINGENCIES

### 32. Question

Under s.92 of the proposed Standard, some information arising from a present obligation is not disclosed because it can be expected to prejudice seriously the position of the entity.

An entity is involved in a dispute with a competitor, who is alleging that the entity has infringed patents and is seeking damages of \$100 million. The entity recognises a provision for its best estimate of the obligation, but discloses none of the information required by paragraphs 84 and 85 of the Standard. What is the required disclosure?

*Answer*

Section 92 of the proposed Standard states that *in extremely rare cases, disclosure of some or all of the information required by paragraphs 84 – 89 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an enterprise need not disclose the information, but should disclose the general nature of the dispute, together with the fact that and reason why, the information has not been disclosed.* For example, the entity should disclose —

Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of \$100 million. The information usually required by AASB xxx *Provisions, Contingent Liabilities and Contingent Assets*, is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the litigation. The directors are of the opinion that the claim can be successfully resisted by the company.

### 33. Question

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the balance sheet date, a provision of \$60,000 has been recognised. The provision has not been discounted as the effect of discounting is not material. What information should be disclosed?

*Answer*

The following information should be disclosed —

A provision of \$60,000 has been recognised for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years of the balance sheet date.

Source: ED 127 Request for Comment on IAS 37 Provisions, Contingent Liabilities and Contingent Assets

### 34. Question

Entity X is involved in a legal case where a client has fallen down the stairs in their office building and has submitted a claim against them. Relevant dates are —

- Incident 25 May 2005
- Reporting Period 30 June 2005

At the date of preparation of the 30 June 2005 financial statements, the advice from Entity X's legal advisor was that, at the time of the incident, the client was turning to talk to an assistant behind her and the stairs were dry and clean at the time of the incident.

There was expected to be a small payout by Entity X's insurer but it was unlikely that there would be a cost to Entity X. The financial statements as at 30 June 2005 for Entity X were signed off in November 2005.

In December 2005, the client employed an expert who proved that the distance between the stairs in Entity X's building was not 'legal' height, a factor which contributed to the accident. This advice meant that Entity X's insurers were unable to support the claim. The claim was settled by Entity X for \$250,000 in January 2006.

What would be the impact of this incident in the 30 June 2005 financial report under Australian GAAP? What would be the impact in the IFRS financial statements for the year ending —

- 30 June 2005; and
- 30 June 2006 – note that these statements and comparatives were prepared in July 2006.

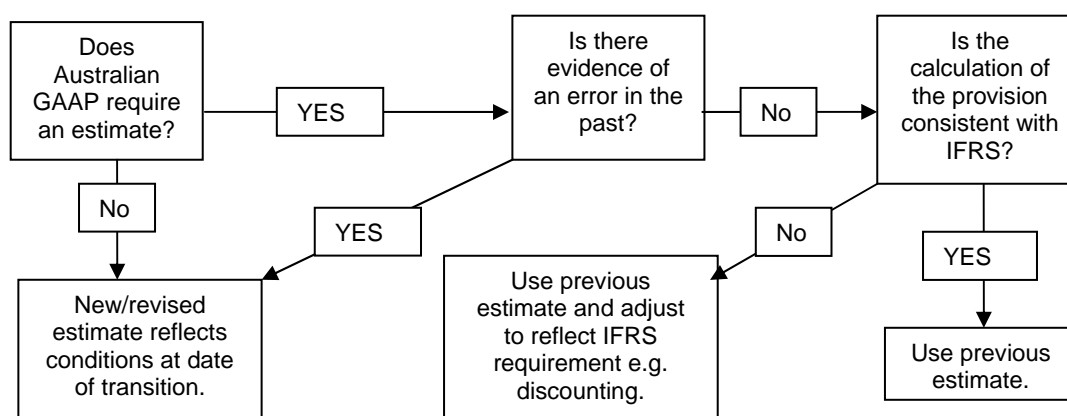
*Answer*

#### Under Australian GAAP - Impact for 30 June 2005

Under AASB 1044, since the possibility of a payout by Entity X was considered unlikely but not remote, a contingent liability would need to be disclosed.

#### Under IFRS - Impact for 30 June 2005

Since the IFRS comparatives have to be prepared for reporting periods ending 30 June 2005, the estimate treatment needs to be considered under IFRS. Refer below.



In this scenario, Australian GAAP requires an estimate (i.e. the contingent liability), and there is no evidence of an error in the past and the calculation of the provision is consistent with IFRS. Given that the expert opinion was obtained in December 2005, it is not considered to be an error.

Therefore, the estimate of nil cost to Entity X is retained (as information from the expert advice was not obtained until December 2005, after the financial statements were completed). Even though Entity X are aware at the time of preparing the financial statement comparatives for 2005 under IFRS that the payout of \$250, 000 has occurred, since it is not an error but a revision of an estimate, there is no adjustment necessary.

### Impact for 30 June 2006

The impact in the accounts as at June 2006 would be reflected in the following journal entry —

Dr Expenses	250 000	
Cr Cash		250 000

Source: CPA Australia presentation (March 2004) – The Transition to IFRS: Preparing for Change: Accounting Standards and Financial Reporting Update for the Public Sector (notes developed by WalterTurnbull)

## ED 128 TAX IMPLICATIONS

### 35. Question

ED 128 relates to the issue of an Australian equivalent to the existing IAS 12 Income Taxes. Under IAS 12 a balance sheet approach is to be adopted. Under this method the general principle is that the current and future tax consequences of transactions and other events recognised in an entity's statement of financial position gives rise to current and deferred tax liabilities and assets. Refer example.

An asset is revalued upwards by \$200,000. How is this accounted for under the existing Australian accounting standards and under IFRS?

*Answer*

In Australia —

Dr	Asset	200 000	
Cr	Asset Revaluation Reserve		200 000

Under IFRS —

Dr	Asset	200 000	
Cr	Asset Revaluation Reserve		140 000
Cr	Deferred Income Tax Liability		60 000 <sup>1</sup>

<sup>1</sup> DITL = 30% (company tax rate) x 200 000

## GLOSSARY

**Defined benefit plans** – are post employment benefit plans other than defined contribution plans.

**Vested employee benefits** - are employee benefits that are not conditional on future employment.

**Cash-Generating unit** – is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.

**Recoverable amount** – the higher of an asset's net selling price and its value in use.

**Value in use** – is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. For a 'not-for-profit' entity, value in use is depreciated current replacement cost.

Source: IASB, December 2003, 'International Financial Reporting Standards: Incorporating International Accounting Standards and Interpretations'.

## REFERENCE LIST

CA Business Forum 2004 (12 March 2004) presented by PriceWaterhouseCoopers.

CPA Australia presentation (March 2004) – *The Transition to IFRS: Preparing for Change: Accounting Standards and Financial Reporting Update for the Public Sector* (notes developed by WalterTurnbull).

International Accounting Standards Board, December 2003, 'International Financial Reporting Standards: Incorporating International Accounting Standards and Interpretations'.

QAO, December 2003, 'Applying International Financial Reporting Standards to the Public Sector: Frequently Asked Questions'.

Pending Accounting Standards available at [www.aasb.com.au](http://www.aasb.com.au)

## QAO IFRS PUBLICATIONS

The following publications on IFRS can be accessed via the QAO website at [www.qao.qld.gov.au](http://www.qao.qld.gov.au) —

- Auditor-General Report to Parliament No. 7 (2002-03);
- Auditor-General Report No. 4 (2003-04);
- IFRS Frequently Asked Questions Booklet;
- IFRS Checklist for Public Sector Entities;
- INFORM 11, 12, 13; and
- IFRS related exposure draft submissions also available on the QAO website.

## Disclaimer

This publication is a guide based on information available as at 16 April 2004 and is not a substitute for the Pending Standards, exposure drafts, AASB and IASB Standards. Users of this publication should be aware that the requirements of IFRS could change over time until the release of final AASB equivalents to IFRSs. For further information or clarification, please refer to the AASB website.

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