IFRS as Viewed from the Tax Department

By: Red Moon Solutions

While I've worked on the tax side of the business my entire career, I was always interested when my counterparts in the accounting department would talk about their 'trials and tribulations' in applying the rules and regulations for reporting their fixed assets. After all, they had assets that they were depreciating on a straight line basis over a ten year period, calculating the same amounts year after year. There I was, deciding which depreciation method would provide me with the most favorable tax result—whether to expense the asset in full or partial, calculate bonus depreciation or forgo taking bonus depreciation. Could I force the mid-quarter convention to my benefit and (heaven forbid) be stuck with a luxury auto located on an Indian reservation property? To me, it seems an arduous task!

Recently I was with an accounting counterpart discussing current accounting trends, new issues and the different solutions for each. He was tense, and as we talked I could tell there was a more serious issue than monthly posting entries being off by a few pennies. I asked him how much he was out of balance for the month: a dollar and change? Hadn't he heard of the "miscellaneous office supplies" account?

He replied: "Haven't you heard of the new IFRS requirements that are going to be rolled out?" His mood shifted as I joked: "IFRS? Is that a new accounting ploy for accountants who can't balance their books?"

Open mouth, insert foot.

Perhaps all of us in the tax world should be more understanding of our counterparts in the accounting world. We should, in fact, start by trying to understand some of the basic rules that will be changing the accounting and financial reporting requirements for the business (which will impact your business, as well). Through example, I will explain the new procedures as they relate to the property, plant and equipment accounts of the business. As a prefix, just like in tax, the following data is based on current interpretations and is subject to change as the SEC and other regulatory bodies work on issuing the prescribed procedures.

Before we begin, let me re-define some of the accounting terms that are being used so that we can better relate:

A) Property, Plant & Equipment - For simplicity, I will define what is NOT included. The following lists the most common items but is not all-inclusive:
A right to use the land that is included in the purchase price of a building. The amounts related to the actual building and the right to use the land would be segregated based upon the relative FMV of each item.
Items of inventory:
Intangible assets, such as goodwill and special licenses
Mineral rights and reserves

B) Recognition of assets – when assets are acquired and placed into service
C) Carrying amounts – original cost or other basis when assets are acquired
D) Impairment losses – asset's net book value exceeds asset's FMV (less disposal fees)
E) Residual value –asset's estimated salvage value at the end of asset's useful life
F) Derecognized – when said asset is sold
G) Depreciation method – the method used is not a free choice – it relates to the asset's consumption of the future economic benefits. Company policy can also dictate the method
H) Useful life – unlike MACRS recovery periods, useful life is based on some or all of the following:

- Assets expected usage. This is based on an asset's expected capacity or physical output
- Assets expected physical wear and tear. This is based on a number of items, such as the time use of the asset during operations (i.e. is it running 24/7 or just during a regular day shift), the repair/maintenance cycle of the asset, or whether it is in use or is idle
- Asset's obsolescence due to changes in technology and/or market demand
- Legal issues if it relates to a lease term or management policy relating to the replacement policy period (i.e. company-provided cars are replaced every two years no matter the use or condition at the end of the time frame selected)

The only other item needing clarification is the determination of the 'original' cost basis for depreciation purposes (carrying amount). The following items would be included in the cost basis:

1) Initial contract/acquisition price
2) Purchasing fees, such as legal and brokerage fees, import duty fees and non-refundable purchase taxes less any trade discounts and/or rebates.
3) Direct costs that are attributable to bringing asset up to a state of readiness, such as site preparation fees and/or delivery charges.
4) An estimate of any costs that may be required to dismantle the asset at the end of its useful life and restore the site to its original use.

5) Salvage value or residual value estimated at the end of the asset's useful life.

Using the above information I can explain the new role IFRS plays in the business. Assume the following facts and amounts:

- A manufacturing machine is purchased with a list price of $250,000 on April 4th.
- Taxes and delivery charges amounted to $16,250
- Direct costs (including labor) to prepare the site to house the machine amounted to $46,000
- The economic useful life of the asset (determined by management from the recognition date) is estimated to be 10 years, and the usage will be consistent over the asset's life. At the end of its useful life, the original asset will need to be replaced. There is no residual value; however, it will cost approximately $21,750 to dismantle and remove the asset from its location prior to installing its replacement.
- The machine is finally installed and operational on July 1st.

The first step is to determine the original cost (initial recognition). This would be $334,000 and the date in service would be July 1st. The annual depreciation amount for this asset would be $33,400 based on the measurement at initial recognition. All of the above costs would be includable. Based on these facts, the initial year depreciation to be recorded for this asset would be $16,700.

Based on the above, what would happen in year five if management revises its original estimates for useful life to now be 15 years from the initial recognition date and the salvage value to now be $25,000?

First, one must revise the carrying amount of the asset by reducing the initial amount downward to $309,000 to reflect the $25,000 new estimated salvage value. Next, the revised useful life of 15 years needs to be adjusted to reflect the three and one-half years that have already passed. The accumulated depreciation through the end of year four is $116,900.

The revised amount of depreciation would be based on the following scenario: The initial recognition cost of $334,000 is reduced by the new estimated salvage value of $25,000, making the revised cost equal to $309,000. Since we are in year 5 of the asset's life, an adjustment of the revised new estimated life is needed—from 15 years down to 11.5 years. 3.5 years have been used. The new annual depreciation expense would be $28,091 (rounded). Accordingly, the journal entry to record this event would be a debit to profit/loss (depreciation expense) and credit to accumulated depreciation for the $26,870.

In a twist to this example, there is a fire in the plant in year 6. The carrying amount of the machine is now estimated to be $150,000. The current carrying amount is $165,230. This results in impairment loss of $15,230 for the current year. This amount is recognized in profit/loss for the year-end reporting as a debit to profit/loss (depreciation expense) and a credit to accumulated depreciation.
Finally, the asset is derecognized (fully disposed of) in year 7. The asset is sold on June 30th for $125,000. Depreciation for one half of period 7 is $27,890. The carrying value on the date of disposition is $142,105, resulting in a loss of $17,105.

After going over these examples with my friend, it was obvious that his company's current ERP subsystem would either need to be customized or replaced in order to accommodate multiple sets of books and to calculate different amounts of depreciation for the same asset. He acknowledged the fact that he thought the company would be reluctant to make this change and dreaded the thought of trying to keep two sets of books.

"Welcome to my world", I said, "I've been keeping a minimum of three different sets of books over the last several decades!" I quickly added, "And no, I'm not talking about the books I keep for Uncle Sam and the books I take home. The IRS *requires* me to keep three sets of books: one for Federal tax, one for the Alternative Minimum tax and one for ACE".

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In my use of technology to address these complex situations, I am able to focus my time and energy on those business tasks that have greater importance to my company. As rules change and my company's position changes, I can rest assured that the software can accommodate my needs.

As I finished the discussion with my colleague, it was apparent to both of us that this is the time to start evaluating our current ERP systems to see how (and if) they would be able to accommodate these and other changes like these in the future. Now is the time to start taking action in order to be prepared. Now is the time to get the results you want.

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